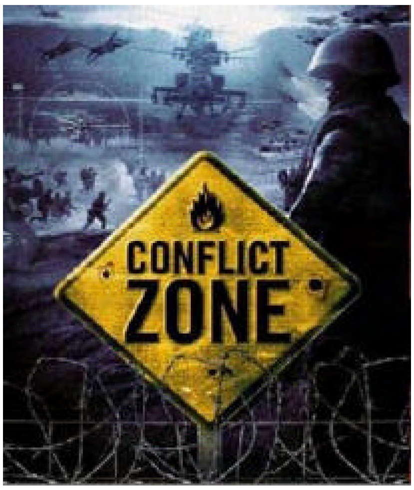
USAID WESTBANK AND GAZA

MIRCROFINANCE SECTOR ASSESSMENT

EVALUTION OF CHF

EVALUATION OF FATEN

NEW ACTIVITY DESIGNS



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List of Abbreviations

ACAD	Arab Centre for Agricultural Development
ACP	Access to Credit Program
ANERA	American Near East Refugee Aid
ASALA	Palestinian Business Women Association
CGAP	Consultative Group to Assist the Poorest
CHF	Cooperative Housing Foundation
DFID	(UK) Department for International Development
EIB	European Investment Bank
EU	European Union
FATEN	Palestine for Credit and Development
FSS	Financial Self Sufficiency
GDP	Gross Domestic Product
GGLS	Group Guarantees Lending and Savings
IDA	International Development Association
IFC	International Finance Corporation
JD	Jordanian Dinar
KfW	Kreditanstallt fur Wiederaufbau
MENA	Middle East and North Africa
MFI	Microfinance Institution
MMP	Microfinance and Micro-enterprise Program
NIS	New Israeli Shekel
NGO	Non Governmental Organization
MIS	Management Information System
OSS	Operational Self Sufficiency
PA	Palestinian Authority
PAR	Portfolio at Risk
PARC	Palestinian Agricultural Relief Committees
PBC	Palestinian Banking Corporation
PNA	Palestinian National Authority
PMA	Palestinian Monetary Authority
POS	Point of Sale
SSC	Savings and Credit Cooperative
UNRWA	United Nations Relief and Works Agency
USD	United States Dollar
USAID	United States Agency for International Development
WB	World Bank
WBG	West Bank and Gaza

Executive Summary and Recommendations

I. Sector Assessment

The Palestinian microfinance sector has proven to be remarkably resilient during the years of the second Intifada. The onset of the Intifada and the Operation Defence Shield in April 2002, resulted in a 30 percent decline in the number of active clients, from 17,200 year end 2001 to 12,000 year end 2002. Since then the sector has not only recovered but also more than doubled in size measured in number of active clients: year end 2005 the industry served almost 28,000 active clients with an outstanding portfolio of over USD 35 million. UNWRA's micro enterprise lending program has remained the market leader throughout the Intifada period. Below follows a summary of the most salient features of the microfinance sector in the West Bank and Gaza:

Coping Strategies under Conflict:
Overall, the following trends can be observed in the Palestinian microfinance sector's Intifada coping strategy: (i) reduction in lending; (ii) the introduction of tighter guarantees such as salary guarantees; (iii) decrease in exposure (through decrease in average outstanding balance); (iv) the emergence of savings and credit cooperatives; and (v) the emergence of the Palestinian Microfinance Network.

An estimated 25-30 percent of all outstanding loans were written off during the early years of the Intifada. In subsequent years however, many clients managed to repay once they had the funds to do so. The average loan recovery rate on written off loans is an estimated 40 percent.

Commercial Microfinance:
While in the past banks have successfully engaged in microfinance in the West Bank and Gaza– notably under an USAID funded project – banks nowadays have no appetite to engage in retail lending to micro businesses. More over, the hurdles that banks create to open savings and even current accounts (high minimum amounts) indicate that there may be room for bank engagement in the provision of savings and deposit services. It remains to be seen whether the newly established micro and small business bank – Alrafah Bank – will be a successful model as it appears to be risk averse and may have possible governance weaknesses.

Internal Challenges:
The microfinance sector faces a variety of challenges that need to be overcome in order for the sector to rapidly expand and integrate into the formal financial sector. These challenges include legal and governance issues. The majority of MFIs are registered as a NGO, a structure that is not conducive to expansion. The most characteristic feature among most MFIs – irrespective of their legal form – is weakness at the governance level that needs to be addressed.

Market Limitations:
The market for microfinance is limited in the West Bank and Gaza and most MFIs offer the same product to the same target groups. Most MFIs also offer certain loan products that are similarly offered by banks with the same terms and conditions. It remains to be seen whether scarce donor money should be used to provide loan products to target groups that banks serve out of their own funds. There is ample room for product development in order

to provide more tailored products for the clients (instead of trying to fit a client's needs into the straightjacket of the existing loan products).

The Sustainability Target:
The achievement of operational sustainability has become a goal in itself and not a means to achieve (financial) independence and build a larger client base. The concept of financial sustainability – the ability to borrow commercial funds for onlending – is not engrained in the mindset of the MFIs. The sector is very dependent on grants, not only for funds for onlending but also for funding other operational activities such as staff training and product development.

Impending Crisis: Government Salaries
The most urgent challenge is the evolving crisis with over 150,000 government employees (supporting about one million people – more than 25 percent of the population) not receiving their salaries, the Israeli government's suspension of tax transfers as well as diminishing donor support for the Palestinian Government. The Palestinian economy is at the brink of collapse and poverty and unemployment are increasing on a daily basis.

The Palestinian microfinance sector appears to be ill-prepared for the unfolding crisis. The sector has concerns regarding donors coming in and using the sector's infrastructure to disburse large amounts of humanitarian grant money to the poor. The sector also has concerns about the loss of its capital base: an estimated 30 percent of all loans outstanding are currently at risk, mainly due to the fact that many MFIs use salaries – which are not paid – as guarantees. Thousands of families are without income and have to focus on their basic household needs for survival, not having cash flow to repay loans.

II. New Activity Design for the Emergency Case scenario

The objective of the new activity for the emergency case scenario is to preserve the Palestinian Microfinance industry and its capital base while providing short term relief to those clients living below or just above the poverty line (about 10,000 families).

The team proposes a loan recovery matching grant scheme combined with a partial coverage of operational costs to preserve the physical and financial infrastructure of the sector.

Under this scheme, MFIs would try to maintain loan portfolio quality as well as possible but would write off loans after they have been overdue for more than 6 months. As the experience in the past has shown, MFIs do recover part of the written off loans. The loan recovery matching grant scheme will match any amount recovered after the crisis ends on a one-to-one basis. In this way MFIs will not deplete their capital base. The proposed partial coverage of operational costs will achieve the same objective and will enable he MFIs to continue to function and maintain their staff and infrastructure.

Empirical evidence indicates that in other countries where ("man-made") humanitarian disasters occurred, micro-grants were found to be an appropriate solution to provide relief. The team however strongly believes that such an instrument will not work in the West Bank and Gaza. The use of grants may bring the industry down – which has so painstakingly being build during the last 10 years – and would destroy the repayment discipline.

The team proposes to introduce zero-interest social safety net loans and social safety credit cards for social safety purposes only with a grace period equal to the duration of the emergency – which is expected to last up to 6 months. These products are a one-time product and should be carefully tailored and targeted towards the poorest clients. With such a product the MFIs can show their clients that they respond to their needs – even in the most difficult times. The concept of emergency loan exists in the Arab culture and is known as *Al Qard Al Hassan*. The estimated budget for the emergency new activity is about USD 22 million.

The recommendation section at the end of this executive summary contains a detailed description of steps to be undertaken to implement the emergency new activity. After the submission of the draft report, USAID also informally requested the team to develop another emergency scenario assuming that only USD 10 million would be available and that only those MFIs that would sign the ATC would be eligible. Recommendations for this scenario are included in the recommendation section. The team would like to emphasize that under this scenario only one MFI would be eligible (CHF) and that this MFI will not be able to absorb the USD 10 million. USAID is urged not to pressure CHF to disburse more than what would be prudent (USD 5.5 million).

III. New Activity Design for the Normal Scenario

Once the microfinance remerges from the crisis – with the support of the above described emergency interventions - and people can slowly rebuild their life, the sector may be able to face the other challenges mentioned earlier.

In order for the sector to build a base for rapid expansion, transformation and integration into the formal financial sector, the team proposes a Guarantee Facility for bank loans to MFIs and a Capacity Building Innovation Facility.

The Palestinian banking system has over USD 2 billion in excess liquidity which is not invested in the Palestinian economy. In stead of using scarce donor grants as source for onlending MFIs could borrow from banks for onlending. Banks however need to have incentives to do so. The proposed Guarantee Facility would guarantee bank loans to MFIs. This would set a new best practice standard in the West Bank and Gaza and move the microfinance industry towards financial sustainability. USAID could use its 'own' DCA program to implement such a guarantee facility, or could consider funding a special 'window' for microfinance in the KfW European Palestinian Credit Guarantee Fund which is about to become operational.

The Capacity Building and Innovation Facility will co-finance capacity building needs of individual MFIs and the sector as a whole on a matching grant basis. The Facility will also make funds available for pilots and experimentation as well as funds to improve the legal environment. The total budget for the Normal Case Activity is – depending on the size of the guarantee facility – up to USD 20 million.

IV. FATEN & CHF-ACP

While FATEN and CHF are remarkably similar in terms of basic indicators (such as number of active clients, loan portfolio outstanding and operational self-sufficiency), they differ in core structure. Whereas CHF is an advanced lending *program*, FATEN is a mature microfinance *institution*.

FATEN is the strongest of all MFIs operating in Palestine to date. FATEN's key strengths include a very positive reputation in the community for serving women, a well-established experience in group lending methodology targeting the poorer segment of women entrepreneurs, a comprehensive individual credit methodology, an effective MIS, and very strong and systemized internal control procedures.

FATEN has opportunities to improve by formalizing the Board functions through internal rules and committees, developing a long-term business plan, ensuring access to commercial funds to eliminate total dependence on donor grants, increasing staff productivity, as well as eliminating subsidized, riskier product lines (consumer loans and home improvement loans).

FATEN's principal risks in the current crisis situation include downward pressure on profitability with declining portfolio yield, a slowdown of lending activity, a soaring default rate, and pressure on management to deal with yet another unfolding crisis due to the suspension of salary payments, tax transfers and donor funding: while the portfolio at risk over 30 days (PAR > 30 days) stood at 4 percent at the end of April 2006, the PAR > 1 day stood at 24 percent. This is expected to increase as the salary crisis continues.

The Access to Credit Program (ACP) of CHF is an experienced and strong program in the area of house rehabilitation loans serving household living below or just above the poverty line. It has a unique loan product that is accompanied by engineering advice for the client concerning the construction work to be financed. ACP has a strong market position in this area and a well managed system for loan application, disbursement and follow up.

The ACP is yet a lending program implemented by a larger multi-facetted international NGO but has systems, people and CHF HQ commitment in place to transform (legally and institutionally) into a separate microfinance organisation under more stable political and economic circumstances. In order to achieve full financial sustainability – and independence from donor funds – product and target group diversification is essential (which ACP already started doing so) as the yield on the housing loan portfolio appears too low to cover all operational and financial costs.

While CHF-ACP has had an excellent loan portfolio quality (with PAR > 30 days) less than 3 percent throughout the Intifada until March 31, 2006, the portfolio at risk has increased in April. PAR over 30 days stood at 7 percent while PAR over 1 day stood at 30 percent. The PAR is expected to increase even more as all loan are guaranteed by salaries which have not been paid for the last few months.

USAID has made two excellent investments in CHF and FATEN and by doing so has contributed to the development of a *best practice* microfinance environment in the West Bank and Gaza. USAID is advised to push the best practice agenda, and to implement a novel program, creating incentives for the two organizations to become – over time –

independent of USAID funding, through the implementation of the guarantee facility for local bank finance for onlending described under the normal case new activity design.

USAID is recommended not to distribute the evaluations of FATEN and CHF as these contain confidential data.

V. Recommendations New Activity Design for Emergency Period

I. Loan Loss Recovery Matching Grant Scheme and Operational Cost Partial Subsidy	
Objective:	Preserve the capital base of the microfinance sector as a whole
Eligible MFIs:	All good practice MFIs: CHF, FATEN, UNWRA, ACAD, ASALA and PARC. *Note: Alrafah Bank is excluded as this bank has not yet a track record and hence also no clients with a credit history.*
a. Loan Loss Recovery Matching Grant Scheme	
Approach:	▪ As per microfinance good practice write off policy, MFIs write off loans after they have been overdue for more than 180 days. ▪ Any amount recovered after write off over a period of one year is matched on a one-to-one basis by USAID. *Note: the matching period could be extended to a period of 2 or even 3 years depending on the severity of the crisis.*
Budget:	▪ Budget estimates are based on historical data on loan write offs during the first two years of the second Intifada. Estimated loan write offs were USD 5 million. ▪ Assuming that the expected write offs in the future would at least be the same amount, and assuming an average recovery of 60 percent, USD 3 million would be the required budget for the matching grant scheme. *Note: this is a minimum required amount as loan losses are expected to he higher. The estimated average portfolio at risk (over 30 days) is currently (June 2006) 30 to 40 percent: if all these loans will remain in arrears, by the end of the year 2006, at least USD 10 million would have been written off (30 percent times USD 35 million outstanding year end 2005) and at least USD 6 million would then be required for the matching grant scheme..*
Activities to be undertaken by implementing consultants:	▪ Determine an appropriate 'starting' date for loans that have gone in arrears: this date could be retroactively (i.e., starting date of the salary crisis, resulting in higher budget for matching grant scheme) or could be date of the start of the implementation of the emergency program. In

	order to avoid misuse of the scheme, USAID is recommended to use the starting date of the implementation as the starting date of loans going into arrears. ▪ Verify and re-assess budget required for matching grant scheme; consider in case of budget constraints a lower matching grant percentage.
b. Subsidy of Operational Costs	
Approach:	▪ MFIs receive a 50 percent subsidy on the monthly operational costs in order to enable them to maintain staff and infrastructure ▪ Subsidy paid only during the emergency period which is expected to last at least 6-8 months
Budget:	▪ Budget is based on the year end estimated monthly operational costs of the 6 eligible MFIs: USD 300,000 in total per month. For a 8 month period this would be USD 1.2 million (50 percent x USD 300,000 x 8). *Note: this amount would increase if the emergency period will be longer.*
Activities to be undertaken by implementing consultants	▪ Verify and re-assess the expected duration of the emergency period. If longer, the required budget will be higher. ▪ Obtain year end audited financial statements of MFIs to verify the monthly administrative costs. Exclude costs of loan loss provisioning as these are dealt with under the matching grant scheme. ▪ Decide whether to subsidize operational costs retroactively (see also above) or to start providing these subsidies from the starting date of the implementation of the emergency program. The latter is recommended to avoid misuse.
II. Social Safety Net Loans	
Objective:	Provision of emergency loans to the most needy clients with a good credit history
Target group:	▪ Existing clients of the MFIs mentioned under I. ▪ Minimum credit history: 1 year ▪ Maximum loan received throughout credit history USD 1,000 ▪ Maximum monthly household income USD 600 ▪ Excellent repayment history (i.e., no arrears)
Approach:	▪ Carefully tailored and marketed zero-interest emergency loans (Al Qard Al Hassan) ▪ One time loan only ▪ Loan size up to USD 1,000 ▪ Grace period equal to the estimated emergency period (6-8 months) ▪ Repayment after the end of the emergency period in instalments

Budget:	▪ Budget is based on the year end 2005 data on loan balances outstanding to existing clients. Eligible clients include: all group clients (7,000) and those clients having small individual loans (an estimated 3,000 clients) ▪ 10,000 clients times USD 1,000 is USD 10 million
Activities to be undertaken by implementing consultants	▪ Verify and re-assess the number of estimated eligible clients – the number could be lower as more clients are expected to be in arrears. ▪ Verify and re-assess budget requirement for each MFI. ▪ As CHF has no loans outstanding of less than USD 1,000 (given the nature of its lending program – housing rehabilitation loans), it would not qualify. In order to address this issue, take CHF clients which have an household income of less than USD 600 monthly with a excellent repayment record. ▪ Determine appropriate repayment schedule ▪ Determine disbursement mechanism to the MFIs
III. Social Safety Debit Card	
Target group and objective:	Same as above. *Note: the Social Safety Debit Card is in effect very similar to the Social Safety Loan. It is however packaged differently, includes bank involvement and can be also used after the end of the emergency period for for instance future normal loan disbursements.*
Approach:	▪ Card is issued by MFI in cooperation with a bank ▪ Card is fully funded by USAID ▪ Zero interest in first year; 8-12 percent in thereafter on outstanding balance
Budget:	▪ Budget is based on the year end 2005 data on loan balances outstanding to existing clients. Eligible clients include: all group clients (7,000) and those clients having small individual loans (an estimated 3,000 clients) ▪ 10,000 clients times USD 500 is USD 5 million
Activities to be undertaken by implementing consultants:	▪ Verify and re-assess the number of eligible clients ▪ For CHF, take clients with a household income of less than USD 600 monthly and an excellent credit history ▪ Work out card issuing details with a bank – Cairo Amman bank has shown interest to issue the cards on behalf of the MFIs ▪ Determine disbursement schedule: either USAID disburses to MFIs which then 'buy' the cards from the bank(s) or USAID disburses to the bank(s) directly.
Estimated costs and duration	▪ Assuming a full time international consultant for a

of implementation	period of at least two years, the annual budget would be at least USD 200,000 excluding travel. ▪ Minimum budget hence would be USD 400,000. ▪ In order to allow for contingencies etc., it would be prudent to budget at least USD 500,000.

IV. Recommendations New Activity Design for Emergency Situation if only USD 10 million would be available and only those MFIs can participate that have signed the ATC

Remarks	▪ In this case only CHF would be eligible as the other (non American) MFIs have made the principal decision not to sign the ATC. ▪ The other two remaining American MFIs are not good practice and have limited outreach. These MFIs are considered not eligible. ▪ In this situation, the emergency new activity as described in section V would not meet its objective as the microfinance industry as a whole would not be preserved as only one MFI would receive emergency assistance. ▪ USAID is recommended to actively engage in discussions with the UNDP-IDB project to see whether the other MFIs could participate in an emergency program under the IDB project.
Options	▪ USAID can implement the team's proposed emergency program with CHF, or; ▪ USAID can fund CHF to implement CHF's own proposal for an emergency program as described in Chapter 7. This program is similar (in objective) to the team's proposal but lacks the loan recovery matching grant scheme.
Recommendation	▪ Implement CHF own proposal as this can be implemented very quickly as it involves loan products and lending procedures that CHF is familiar with. ▪ Do incorporate the team's comments on CHF's own proposal. ▪ Add the loan loss recovery matching grant program and the 50 percent subsidy of operational costs.
Details CHF proposal and team's recommendations for adjustment	▪ House rehabilitation loans for families with monthly income of less than USD 400; expected average loan size USD 3,500. Grace period equal to the emergency period. 0-3 percent interest. *Recommendation for Adjustment:* ➢ *Decrease the average loan size to USD 2,500* ➢ *Loans cannot be used to refinance existing loans* ➢ *Zero interest loans, packaged as Al Qard Al Hassan* ▪ Bridging loans for families with household income

	of less than USD 400 to fund emergency household needs. Average expected loan size USD 1500, other terms and conditions as above. *Recommendations for Adjustment* ➢ *Loans cannot be used to refinance existing loans* ➢ *Zero interest loans packaged as Al Qard Al Hassan* ▪ Bridging loans for new clients – terms and conditions as above. *Recommendations for adjustment:* ➢ *Do not offer this product as the new clients will have no credit history.* ▪ Small business 'emergency' loans *Recommendations for adjustment:* ➢ *Do not offer this product as CHF has limited experience with small business lending*
Team's recommendation for additions to CHF proposal	▪ Add the loan loss recovery matching grant scheme; as all loans made by CHF are guaranteed by salaries, the matching grant scheme could in effect 'reward' not so good practice (i.e., salary guarantees). Hence, the matching grant should be lower than a one-to-one basis. ▪ Add the 50 percent subsidy of CHF monthly operational costs (USD 54,000)
Total Budget	▪ Rehabilitation loans: 880 x USD 2500 = USD 2.2 million ▪ Bridging loans to existing clients: 480 x USD 1500 = 720,000 ▪ Loan loss recovery matching grant scheme: assume 50 percent of CHF USD 8 million portfolio will be written off (i.e., USD 4 million). Assume 60 percent recovery: USD 2.4 million. Match this amount on a 75 percent basis: USD 1.8 million. ▪ As the majority of CHF loans outstanding is co-financed with banks, banks should also be eligible for matching grant of their part of the loan loss recovery. This would require approximately USD 500,000. ▪ Subsidy operational costs: 8 months x 50 percent x USD 54,000 = 216,000 **Total budget: USD 5,436,000** ***USAID is recommended not to pressure CHF to disburse more (even if budget available is USD 10 million)***
Activities to be undertaken by implementing consultants	▪ Negotiate with CHF the 'adapted' emergency program ▪ Assess the banks' needs for loan loss recovery matching grant scheme
Budget for implementation	Assume one full time international consultant for 6 months: USD 100,000, and 6 two-week trips for the remaining period of 18 months (USD 20,000 x 6 = USD 120,000). Total budget: USD 220,000

1. Introduction

1.1 Key Principles of Microfinance

Microfinance is the provision of financial services such as credit, savings, cash transfers, and insurance to the poor[1]:

- **Focus on the entrepreneurial poor—**provision of services to low-income clients, women and men, lacking access to other financial institutions.

- **Client-appropriate lending—**simple and convenient access to small, short-term, and repeat loans, with the use of collateral substitutes (for example, group guarantees or compulsory savings) to motivate repayment. Informal appraisal of borrowers and investments (often character based), with simple cash flow and project appraisal for larger and longer-term loans.

- **Provision of secure, voluntary savings services,** which facilitate small deposits, convenient collections, and ready access to funds, either independently or with another institution.

Microfinance is a poverty alleviation tool. The provision of financial services to the poor helps to increase household income and economic security, build assets, reduce vulnerability, and create demand for other goods and services (especially nutrition, education, and health care). When possibilities for asset management are limited, the role of microfinance in risk management or protective strategies may be as or more important than income generation in preserving a household's standard of living.

The Consultative Group to Assist the Poor (CGAP) has developed a set of Key Principles essential for building financial systems for the poor, which is presented below.[2]

Box 1: Key Principles of Microfinance

1. **Poor people need a variety of financial services, not just loans**. In addition to credit, they want savings, insurance, and money transfer services.

2. **Microfinance is a powerful tool to fight poverty**. Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.

3. **Microfinance means building financial systems that serve the poor**. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.

4. **Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people**. Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from donors and governments.

5. **Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services**.

[1] Source: "Microfinance in the Arab States – Building Inclusive Financial Sectors", UNCDF 2004

[2] The CGAP is a consortium of 28 public and private development agencies working together to expand access to financial services for the poor in developing countries.

6. **Microcredit is not always the answer**. Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.

7. **Interest rate ceilings hurt poor people by making it harder for them to get credit**. Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people.

8. **The job of government is to enable others to develop financial services, not to provide them directly**. Governments can almost never do a good job of lending, but they can establish a supportive policy environment.

9. **Donor funds should complement private capital, not compete with it**. Donor subsidies should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits.

10. **The key bottleneck is the shortage of strong institutions and managers**. Donors should focus their support on building capacity.

11. **Microfinance works best when it measures—and discloses—its performance**. Reporting not only helps stakeholders judge costs and benefits, but it also improves performance. Microfinance institutions (MFIs) need to produce accurate and comparable data on financial performance (for example, loan repayment and cost recovery) as well as social performance (for example, number and poverty level of clients being served).

1.2. Microfinance in the Middle East and North Africa

Microfinance in the Middle East and North Africa is a 'young' industry compared to other parts of the world. It has rapidly evolved from a nascent sector into a fledgling industry. Overall the sector's performance can be characterized by[3]:

- **Significant Growth in Outreach.** The number of active borrowers has grown more than tenfold from 129,000 year end 1999 to almost 1.3 million active clients in September 2005 with over USD 500 million in loans outstanding. Growth rates (in numbers of clients) between the countries have differed dramatically. The 50 members of the regional microfinance network – Sanabel – are estimated to serve together over 80 percent of all active clients.

- **Limited Market Penetration.** Significant progress was made in increasing market coverage going from roughly 3 percent of the market served to almost 20 percent of those needing and wanting credit. However, this still leaves an estimated 3 million entrepreneurial poor who lack access to finance. In addition, microfinance serves only 22 percent of rural populations, estimated to be approximately half[4] of the population of the surveyed countries.

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[3] Sources: (i) UNCDF: 'Microfinance in the Arab States – Building Inclusive Financial Sectors' October 2004; (ii) www.sanabelnetwork.org – Third Annual Conference; and (iii) www.mixmarket.org – Benchmarking Arab Microfinance.

[4] Source: http://www.un.org/esa/population/publications/wup1999/WUP99ANNEXTABLES.pdf

- **Lack of Product Diversification.** Microfinance services in the region remain very credit oriented. Aside from some experience with housing finance, most loans are for business purposes. Voluntary savings, deposits services, insurance are generally not offered. The notable exceptions are Yemen and Palestine where the number of voluntary savers is growing rapidly. Savings services are also offered in Syria.

- **Entry of New Market Leader.** Traditionally, Egypt has been the market leader in the region in terms of active clients. However, in 2001 Morocco assumed this position and today holds 43 percent of the regional market share.

- **Increased Focus on Women.** The region has seen a significant improvement in terms of outreach to women borrowers. Up from approximately 17 percent women in 1999, currently 61 percent of all clients in the region are women. Given that women also make up the majority of the world's poor, it is not surprising that this has been accompanied by an overall increase in the depth of outreach.

- **Group Lending Dominant Methodology.** Group lending continues to be the predominant lending scheme, particularly in Morocco, Jordan and increasingly Egypt where it is seen as an effective tool for reaching women. In all other countries individual loans are more prevalent.

- **Broad based Application of Industry Norms and Procedures.** Over 90 percent of all active borrowers in the respective countries are served by good practice MFIs defined as MFIs that adhere to good practice standards and that have sustainability as an explicit objective. The notable exceptions are Tunisia and Syria where government sponsored programs that do not adhere to good practices dominate.

- **NGO as the Dominant Legal Model.** Apart from a few notable cases of successful bank engagement and MFI transformation, the majority of MFIs in the region are NGOs, which continue to be dependent on abundantly available donor (grant) funds for their growth. An emerging trend is establish MFIs as Limited Liability Company due to the lack of a clear NGO legal framework in some countries or the lack of not-for-profit legal option.

- **High Portfolio Quality or Less Taste to Serve Risky Clients?** Compared to other regions, MFIs in the Middle East and North Africa maintain exceedingly high portfolio quality. While this may speak well for the MFIs' operations, it may also indicate that regional institutions do not lend to very risky clients, perhaps under serving a population already lacking many formal financing options.

2. Microfinance in the West Bank and Gaza – Sector Assessment

2.1 Non-Bank Microfinance Institutions and Programs

There are 10 non-bank microfinance institutions (MFIs) in the West Bank and Gaza. Year end 2005, these MFIs served almost 28,000 active credit clients and approximately 3,000 voluntary savers through a network of 72 branches. The market assessment includes the 7 major microfinance programs as shown below. Three minor programs were excluded due to the small number of clients served and insignificant outstanding portfolio relative to the market.

Table 1a: Non-Bank Microfinance Programs included in the Sector Assessment

Name Institution	Start microfinance operations	Legal Form	Legally and operationally independent microfinance operation	Number of Active Credit Clients y/e 2005
UNRWA – MMP	1991	UN organisation	No	11,954
FATEN	1995 (under SC) 1999 (FATEN)	Not-for-profit company	Yes	4,777
ACAD	1989 as company – 1992 as NGO	Non-profit NGO	Yes	2,019
CHF	1995	International NGO (US)	No	3,738
PARC	1999	Cooperative	Yes	2,019
ASALA	1997 (as project under Oxfam); 2001 as re-registered as local NGO	Non-profit NGO	Yes	2,066
YMCA	1999	Non-profit NGO	No	1,277
				27,850

Table 1b: Non-Bank Microfinance Programs excluded from the Sector Assessment

Name Institution	Start microfinance operations	Legal Form	Reason for Exclusion	Number of Active Credit Clients y/e 2005
ANERA	1995	International NGO	Insignificant player	290
GWLF	NA	Local NGO	Insignificant player	260
Al Amin	NA	For-profit company	No data	No data
PBC	NA	Non-deposit taking bank	No microfinance	0

2.2 Impact Intifada

The developments in the microfinance industry in the West Bank can only be evaluated in the context of the second Intifada, which began on September 28, 2000. The following period has been characterized by intermittent clashes, invasions, closures, and curfews, resulting in the widespread restriction of movement, massive destruction of personal property, lack of access to markets, and severe curtailment of economic activity.

Despite some resumption in economic growth during 2004 and 2005, the damaging effect of the continued occupation on local economic activity as well as human life and physical capital has resulted in a drop of GDP per capita at year-end 2005 to $1,152. Cumulative real GDP per capita change since year end 1999 has been minus 30.6 percent. Unemployment has increased to 23.4 percent year end 2005 and poverty has increased to 44 percent. In certain areas, such as Khan Yunis and Rafah in Gaza, almost all households are poor. The World Bank estimates that under a 'Normal Intifada' scenario – without the expected emergency – GDP per capita levels would only in 2012 be back to the pre-Intifada level.

Box 2: Microfinance under Conflict

Conflicts erupt for many reasons and have a broad and deep impact on society; the human cost of suffering from conflicts is immeasurable and the economic costs extremely high. Conflict gives rise to operational challenges for MFIs and, often, to delays in their ability to attain scale and financial sustainability. MFIs have to adjust their strategies and operational procedures to manage the following common effects of conflicts on their programs and financial performance indicators:

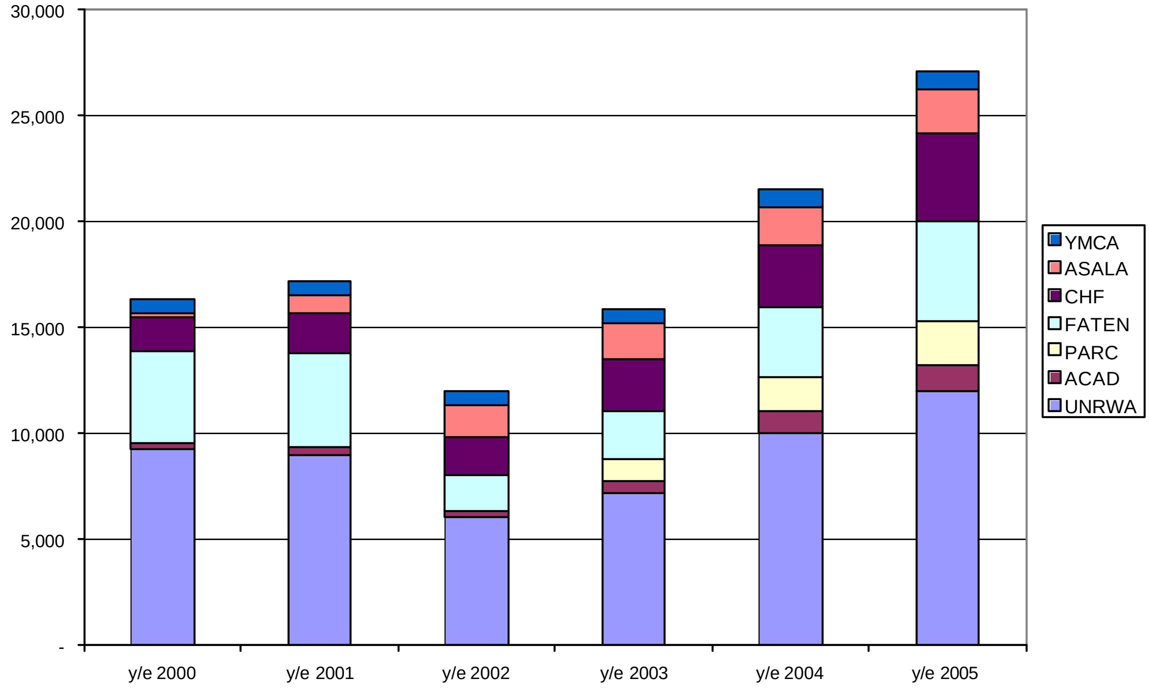
- Increased security risk to staff, clients, and assets;
- Human resource constraints brought about by loss of efficiency and know-how when management, staff, or members of supporting groups flee the country or community, are called to support war efforts, have been killed, or leave for better job or educational opportunities;
- Increase in operational risk resulting from parallel relief-oriented programs, microfinance programs not motivated by long-term development goals, or political and self-interested motivations of local officials;
- Increase in administrative and operational costs brought about by increased monitoring expenses incurred to maintain a high-quality portfolio, additional security precautions, higher labor costs, additional investments in advocacy work, and training and re-training efforts; and
- Overall increase in risk to an MFI's balance sheet and lower returns on investments, given the effects of weakened repayment performance as clients are displaced and their productive and operational capacity is reduced, loan funds are decreased as deposits or lending resources are reduced or frozen, and equity values decline because of inflation and currency devaluations.

Source: Manalo, World Bank 2003.

The Palestinian Microfinance sector has shown a remarkable resilience under the second Intifada: while the industry as a whole experienced a dramatic decrease in number of active clients and loan portfolio outstanding, notably resulting from the spring 2002 invasion and months-long closures and curfews, grinding the economy to a virtual standstill, by year end 2005, the industry had recovered and even experienced a rapid growth. Year end 2002 the number of active clients had dropped with 30 percent compared to the previous year (from 17,200 clients year end 2001 to 12,000 clients year end 2002). Year end 2005 the industry had grown with over 200 percent to almost 28,000 active clients.

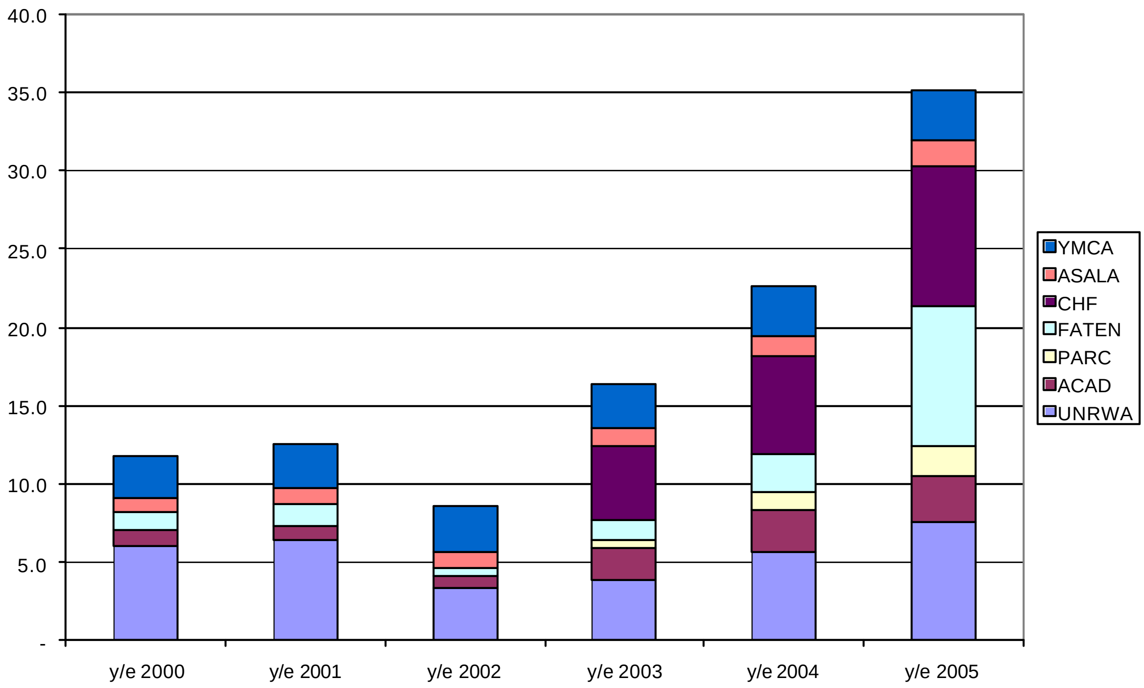
UNRWA's Microfinance and Microenterprise Program (MMP) retained its position as market leader (measured in number of active credit clients served) throughout the Intifada[5].
Year end 2005 it served almost 12,000 active credit clients, resulting in a market share of 44 percent. FATEN, regained its position as second largest provider of microcredit. However, if we would include the estimated 2100 voluntary savers served by the PARC cooperative network as active micro*finance* clients (as opposed to micro*credit*), PARC would be the second largest provider with almost 6,000 members, and FATEN the third largest with 4,777 clients served year end 2005

Graph 1: Evolution of the Number of Active Clients during the Second Intifada



[5] The UNWRA MMP program is currently based in a larger - more socially oriented - organization. Despite this, the MMP has a more commercial orientation. The CHF ACP lending program as well as the former Save the Children lending programs show that such an organisational set-up can be successful. Over time, a separate institution would be required to achieve full financial and institutional sustainability. The strategic goal of the MMP is to become over time a fully capitalized *regional* microfinance *institution* operating in the West Bank and Gaza, Jordan and Syria.

Graph 2: Evolution of the Loan Portfolio Outstanding during the Second Intifada (in USD million)



In terms of loan portfolio outstanding 'market leadership' is less pronounced. Year end 2005, FATEN and CHF shared the first place with approximately USD 8.9 million each in loans outstanding, serving 4,777 and 4,127 clients respectively. UNWRA is the second largest provider with USD 7.5 million outstanding portfolio. More than 50 percent of the total growth in loan portfolio outstanding during 2005 (from USD 22 million year end 2004 to USD 35 million year end 2005) is due to FATEN's introduction of housing loans and family loans (with USAID funding). As we will see later, it remains to be seen whether such types of loans should be funded by scarce donor funds as banks serve the same target group out of their own funds with similar loan terms and conditions.

2.3 Intifada Coping strategy

Individual MFIs coped differently with the Intifada. Some MFIs shifted away from their original target group (women, group loans) and introduced other loan products such as consumer and housing loans for the less poor (guaranteed by salary transfer), at times directly competing with banks. Other MFIs stopped disbursing larger loans (such as small business loans) and used the repayments of these loans to make more group loans. Overall, the following trends can be observed in the Palestinian Microfinance Sector's coping strategy:

(i) Reduction or complete halt in lending;
(ii) Introduction of tighter guarantees such as salary guarantees;
(iii) Decrease in exposure (through decrease in average outstanding balance);
(iv) Emergence of savings and credit cooperatives; and
(v) Emergence of the Palestinian Microfinance Network.

These trends are reviewed below.

2.3.1 Reduction in Lending

As shown in section 2.2, the Israeli invasion in the spring of 2002 severely damaged the Palestinian microfinance sector. While the number of active clients at year end 2001 was over 17,000, this number had dropped by about 30 percent to 12,000 clients year end 2002. Further analysis shows that the decrease in number of clients came mainly from two MFIs, namely UNRWA and FATEN, while the other MFIs either did not grow or grew marginally (see graph 3).

UNRWA and FATEN each 'lost' about 3,000 clients due to high client drop-outs as both served high numbers of women clients borrowing in groups under the group guarantee methodology. These clients are usually among the poorest and were likely the most affected by the impact of the Intifada. It is unclear how many of these client drop-outs returned to the MFI once their household income situation improved.

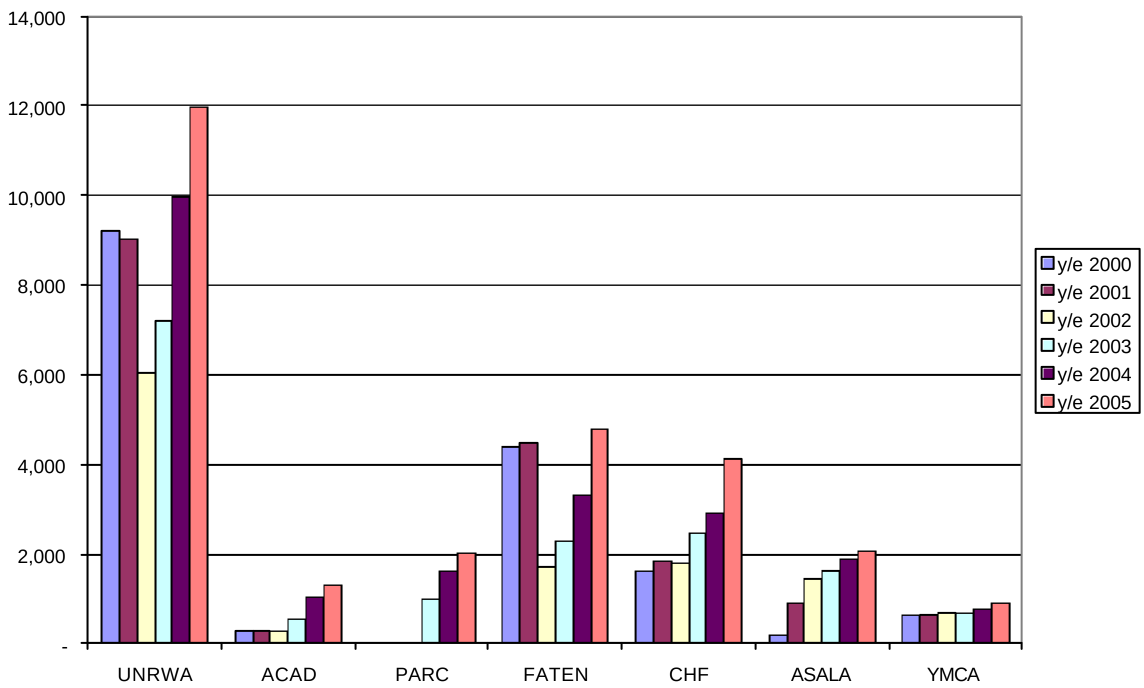
UNWRA was and continues to be adamantly opposed to loan rescheduling, claiming that doing so would affect the integrity of its loan portfolio quality: non-performing loans would 'suddenly' perform again and hence loan officers would get the wrong signals and incentives. It must be noted though that this could be avoided through appropriate MIS ensuring that rescheduled loans are monitored separately.

Since 2001 UNWRA has written off almost USD 4 million in loans. USD 2 million was written off in 2001 and 2002, amounting to about 1/3 of the outstanding portfolio. Loan recovery after write off was up to year end 2005 USD 1.2 million (30 percent).

FATEN rescheduled loans and monitored (and accounted for) the rescheduled loan portfolio separately. FATEN wrote off 24 percent of its portfolio in 2002. Its Board decided to suspend write offs in 2003. FATEN's recovery rate on the written off loans has been an excellent 80 percent.

Other MFIs such as ACAD and ASALA did not write off loans and have as a result a substantial proportion of their loans 100 percent provisioned for (20-30 percent). These loans should be written off but the MFIs lack a clear write off policy.

Graph 3: Evolution Active Number of Clients per MFI during Intifada[6]



CHF had all its loans 'protected' by salary guarantees (see also next section) and had the lowest written off amount. With the impending salary crisis, the impact of the salary guarantee can be immediately observed in the aging of the arrears. The arrears up to 30 days are and have been always quite high for CHF. The salary guarantee becomes effective one month after a loan goes into arrears and as a result the arrears over 30 days are and have been very low for CHF until the end of March 2006. As we will see later – as a result of the salary crisis – the PAR of CHF and FATEN has substantially increased in April 2006.

The cumulative estimated loan losses for the sector as a whole stemming from the Intifada (either write off or loans that have been overdue more than 360 days and have been 100 percent provisioned for) are USD 5 million. This estimate excludes operational deficits incurred due to loss of interest and fee income and higher administrative costs to manage and maintain the loan portfolio.

[6] The number of active clients of FATEN and UNWRA are after write-offs. The number of active clients of some of the smaller MFIs such as ASALA and ACAD include those that should have been written-off (not active anymore) and are hence a bit overstated.

2.3.2. Introduction of tighter guarantees - salaries

Although some MFIs such as CHF have used salary guarantees for years, other MFIs have introduced this practice as an Intifada coping strategy. In order to be eligible for a loan, a borrower has to have 1 to 2 guarantors with a steady monthly salary – usually government employees, UNWRA employees or employees with well known large companies.

MFIs work with banks for loan disbursement and repayment. The banks do a credit check on the guarantor(s), and investigate whether the guarantor himself/herself has a loan already. Such information is usually available on the guarantor's monthly salary-slip The employer issues a salary slip that indicates all direct deductions such as pension funds and bank transfers for loans.

However, MFIs and banks will not know if that person is a *guarantor* as this will not show on the slip. The guarantor has to sign a document allowing the bank/MFI to deduct the instalment due from his/her salary. In case of default, the MFI sends a notice to the bank requesting for the deduction. By Law, a bank cannot deduct more than 1/3 of a person's salary. Hence if the proposed guarantor has already a consumer loan with the bank (or with another bank) against his/her salary, the bank will obviously deduct its portion first, leaving little room for further deductions. Hence double-chipping is usually avoided as the proposed guarantor would be rejected by the bank if he/she already has a loan with the bank, but this will not apply if he is a guarantor at another bank!.

This system appears to be working as banks exchange among themselves information on clients and their creditworthiness The system is less tight as far as the proposed guarantor has loans from non-banks (i.e. MFIs) or is already a guarantor for a borrower of another MFI. MFIs in the West Bank and Gaza do not yet share this type of information.

The team estimates that year end 2005 approximately 40 percent of all active loans was guaranteed by salaries. It remains to be seen whether the use of such guarantees is an appropriate strategy for the MFIs as banks are making similar loans to similar clients with similar terms and conditions. The question then can be asked whether this is a good use of scarce donor money if banks make similar loans with their own money.

Especially those MFIs having a substantial portion of their outstanding loans guaranteed by salaries will be hard hit if the salary crisis continues as there will be no salary to deduct from – as is the case now, with PAR higher than 30 percent. As we will see later, banks – which have heavily engaged into consumer lending during the last few years – have about USD 200 million at risk in such loans guaranteed by salaries.

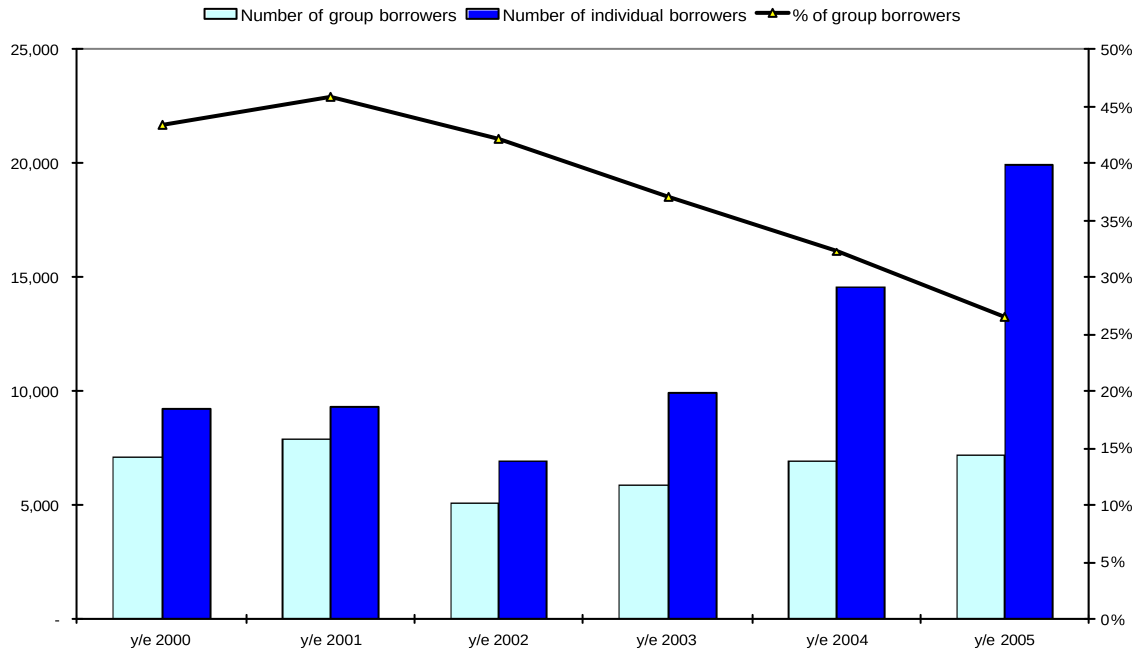
2.3.3 The Demise of Group Lending?

Women taking group loans are among the poorest on the poverty spectrum served by microfinance institutions as they do not have assets or salaries to pledge as collateral which is more common under individual lending. Overall the percentage of women taking group loans decreased during the Intifada (from 45 percent in 2000 to 27 percent in 2005).

Year end 2005 there were almost 7,200 women borrowing in groups. These women could constitute a target group under a possible emergency-loan program under the new activity design. The three main providers of group loans were UNRWA (3,338 clients), FATEN

(2,225 clients) and ASALA (1,635 clients). The average outstanding loan size under the group guarantee methodology was USD 318 for FATEN and USD 277 for ASALA.

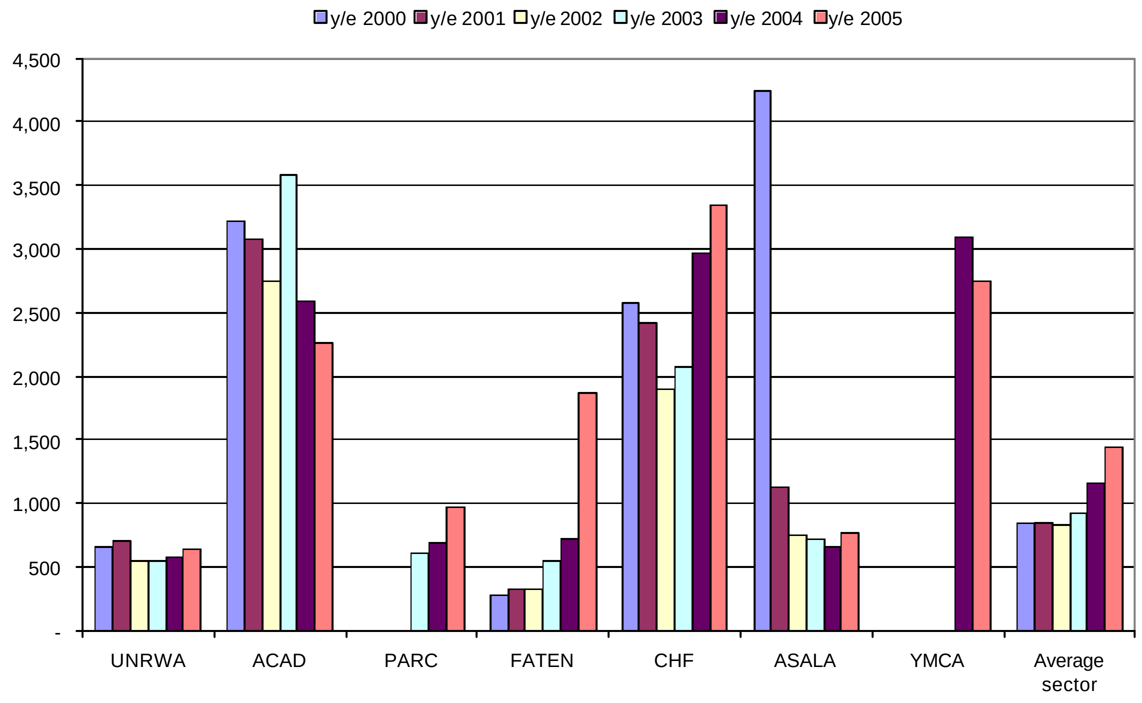
Graph 4: Distribution of Group Borrowers versus Individual Borrowers during Intifada



2.3.4 Decreasing exposures – average outstanding loan balances

If we take the average outstanding loan balance as a proxy for the poverty level of the client, we would assume that the overall average loan size either decreased or did not increase– as repayment capacity of the poor decreased. The sector assessment however shows an counter-intuitive result: average loan size increased.

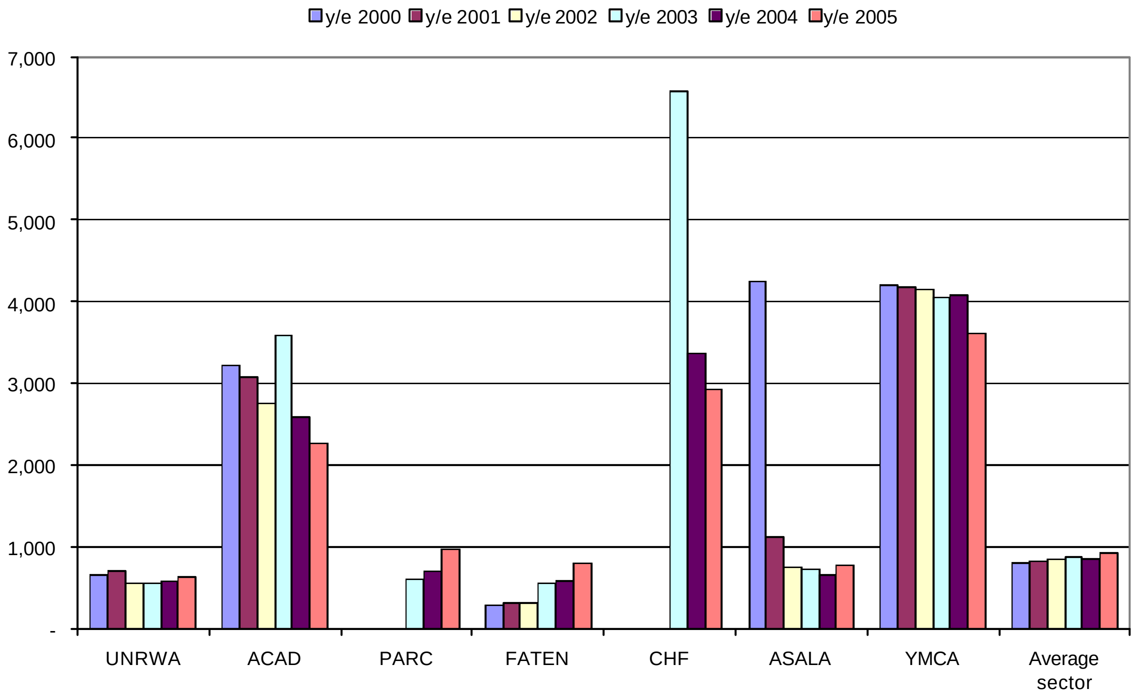
Graph 5a: Evolution of Average Outstanding Loan Balance during Intifada



Further analysis shows that the industry data are skewed because of the following reasons: (i) the introduction of housing finance guaranteed by salaries by FATEN in 2005 (funded by USAID); and (ii) the rapid increase of housing finance by CHF in 2005 guaranteed by salaries (funded by USAID); and (iii) the introduction of family loans by FATEN (funded by USAID) , which are guaranteed by salaries and comparable with consumer loans offered by banks.

If we would remove these loan products , the evolution of average outstanding loan balance of the microfinance sector, shows that the average outstanding balance of the sector as a whole remained below USD 1,000:

Graph 5b: Evolution of Average Outstanding Balance excluding housing and consumer loans



2.3.5 A Novel Coping Strategy – the Emergence of Savings and Credit Cooperatives

Both the Palestinian Agricultural Relief Committees (PARC) – a well established Palestinian NGO, and the Arab Centre for Agricultural Development (ACAD) – an agricultural finance NGO, were instrumental in the establishment of Savings and Credit Cooperatives during the Intifada.

Members in the cooperatives save first to obtain a membership share in the cooperative (which are governed using the one-member – one-vote principal. Savings capital is further enhanced through monthly compulsory savings as well as voluntary savings. According to PARC almost 35 percent of the savings can be considered voluntary. Members of a cooperative decide among themselves on loan eligibility, loan terms and conditions, savings requirements and profit-sharing.

Table 2: Overview Key Indicators Savings and Credit Cooperatives

	PARC	ACAD	TOTAL
# members (savers)	5,785	1,709	7,494
Volume of savings (USD)	1,582,118	460,000	2,042,118
Average savings (USD)	273	269	272
# borrowers	2,019	720	2,739
LP outstanding (USD)	1,949,555[7]	627,000[8]	2,576,555
Average loan balance (USD)	965	638	940
Number of coops	133	40	173

PARC

While PARC had initiated the establishment of savings and credit cooperatives in 1999 (as informal non-registered groups), the growth of the movement took a flight during the Intifada, notably in 2001 and 2002. By year end 2005, the informal groups have grown into a formal network of 12 cooperatives covering 133 groups in all the districts in the West Bank and Gaza. In 2003, the 12 cooperatives were formally registered and started operating autonomously with technical support from PARC. In 2005 the first Savings and Credit Union was established to monitor, expand and facilitate the performance of the PARC associations. To date, the central union is housed within PARC, with three senior PARC staff seconded (at no cost) to the union. The associations operate at district levels through NGOs for Rural Women Development.

Box 3: Savings despite Adversity

Proponents of conventional wisdom believe that under a worsening socio-economic situation, the level of savings among the poor decreases or rather comes to a halt. PARC SCCs defied conventional wisdom and demonstrated an upward turn for savings behaviour under dire conditions (the Aqsa Intifada). PARC conducted an informal analysis of the reasons behind the high demand for their Savings and Credit program, and the main results are summarized below:

* Herd mentality (in initial phase): “others within the Women’s Clubs are saving so I should save as well”
* Women felt empowered and financially independent. They had assets that were theirs.
* Cooperative activities became a favourite past-time. Some women felt the experience was the only positive thing in their lives.
* Access to loans
* Building a fund for children’s education
* Cushion/protection against unforeseen future
* Credibility of the program and strong sense of ownership: run by the women, for the women

2.3.6 The Emergence of the Palestinian Microfinance Network

Early 2002, MFIs and banks started meeting informally to discuss and exchange ideas on the impact of the Intifada and to coordinate policies and procedures to cope with the Intifada.

[7] Includes USD 500,000 grant funding

[8] This includes the savings amount plus an interest free loan of USD 167,000 from ACAD

In the summer of 2002 this informal gathering slowly moved towards some formalization: participants in the gatherings agreed that these meetings would become a more permanent coordination body for the microfinance sector and a chairperson was elected. The network – under establishment – received funding and technical assistance under the USAID ISAMI project. Early 2003 the network approached the Ministry of Interior to be registered as a non-profit association. This was accomplished in April 2004 when the Palestinian Microfinance Network was formally registered. The By-Laws allow all microfinance providers – whether NGO, Company, Bank or International NGO, to become a member. To date the network has nine members: ACAD, ANERA, ASALA, CHF, FATEN, PBC, PARC, UNWRA and YMCA.

The mission of the network is to " develop the sustainable provision of micro and small business finance in order to contribute to the development of small and micro enterprises through representing, supporting, organizing and consolidating the micro and small business finance service providers in Palestine". The objectives of the network include:

- To strengthen and to assist in capacity building for MFIs.
- To insure best practices and sustainability of services provided.
- To improve public awareness on the micro and small business lending programs available.
- To conduct market studies and other research related to micro and small business lending issues
- To create an enabling legal environment for financially sustainable small and micro lending institutions.
- To create a sound competitive environment among finance providers and to strengthen cooperation amongst them.
- To participate in similar networks at the regional and the international level.

In February 2006 the network's General Assembly modified the By-Laws in order to restrict membership to non profit organizations only and hence and excluding the private sector. Apparently this was done in a response to the request of Al Rafah Bank to become a member. Some members feel threatened by the private sector entering the field of microfinance. Restricting the membership is however a regrettable step as open membership – especially for banks – would facilitate bank engagement in microfinance and enable the sector as a whole to provide financial services to many more clients.

The Network's funding needs for 2006 were USD 200,000, to cover its operational costs and to implement training and research programs. The Dutch development organization NOVIB has recently provided the network with a grant of EUR 70,000 to fund the network's operational costs for 2006. EUR 15,000 of this grant is allocated for a microfinance demand study. The Portland Trust has committed itself to fund the remainder of the 2006 budget out of its own funds. The network has developed a three-year business plan for the period 2007-2009 and is seeking grants to fund this plan.

The establishment of the network was very much needed. Donors over the past 10 years have regularly advised the MFIs to establish such network. The delay in the establishment appears to be related to the sense of distrust among MFIs. Even today – MFIs have yet to establish a system to exchange information on 'bad borrowers'. Such as system would be the first step towards the creation of a credit bureau where information on borrowers' track record and credit history is gathered and made available to the sector as a whole. This would enable the sector to assess whether a borrower already has a loan with another MFI, information which is currently not available.

2.4 Bank Microfinance

2.4.1 Banking System in Palestine

The number of banks operating in Palestine has increased from two in 1993 to 22 as of year end 2005, with 138 branches and head offices. Ten banks are Palestinian and the others are regional Arab (11) and non-Arab foreign banks (1). Four of the 22 banks operate based on Islamic Finance principles. The Palestinian Monetary Authority became the supervisory body for all banks operating in the Palestinian Territories in December, 1995. The PMA is not a Central Bank and hence there is no lender of "last resort".

Table 3: Evolution Key Banking Data (in USD million)[9]

	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Oct-05
Assets						
Balances with PMA and banks in Palestine	617	567	531	842	744	718
Foreign Assets	2,316	2,364	2,508	2,537	2,618	2,426
Of which balances with banks abroad	*2,154*	*2,172*	*2,322*	*2,267*	*2,329*	*2,141*
Credit	1,328	1,197	937	1,041	1,383	1,825
Of which to PNA	*483*	*398*	*152*	*259*	*419*	*686*
Of which to Private Sector	*845*	*799*	*785*	*782*	*964*	*1,139*
Portfolio and other investments	332	292	291	306	366	517
Total Assets	**4,593**	**4,420**	**4,267**	**4,726**	**5,111**	**5,486**
Liabilities and Equity						
Deposits of PMA and banks in Palestine	346	317	290	469	346	292
Total Resident Deposits	3,470	3,349	3,275	3,558	3,869	4,083
Of which from PNA	*196*	*188*	*295*	*322*	*479*	*593*
Of which from resident customers	*3,274*	*3,161*	*2,980*	*3,236*	*3,390*	*3,490*
Foreign & other liabilities	527	546	509	476	589	587
Total Liabilities	**4,343**	**4,212**	**4,074**	**4,503**	**4,804**	**4,962**
Capital and Reserves	250	208	193	223	307	524
Total Liabilities and Shareholders' Equity	**4,593**	**4,420**	**4,267**	**4,726**	**5,111**	**5,486**

Lending. The years 2003, 2004 and 2005 saw a relative increase in lending to the Palestinian National Authority (from 16 percent of total lending year end 2002 to 37 percent year end 2005). As of March 30, 2006, no significant change has taken place in the key banking data compared to October 2005.

The lending data are net of provisions. USD 200 million of the USD 686 million in loans outstanding to the government (PNA at national and local level) is guaranteed for by the Palestinian Investment Fund. The remainder of the lending to government is non-guaranteed and hence likely at risk. There is an estimated USD 200 million outstanding in consumer loans to government employees (which are guaranteed by their) salaries. These loans are likely to default if salary transfer is not forthcoming.

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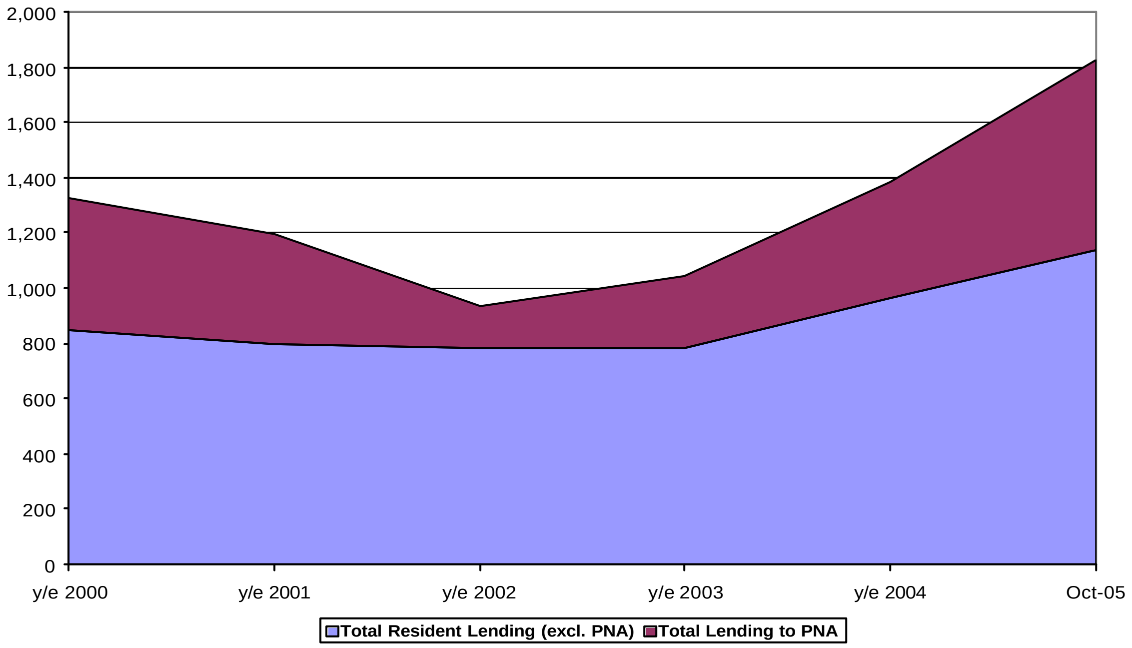
[9] Source: www.pma-palestine.org

Graph 6: Total Lending of the Palestinian Banking System (in USD million)



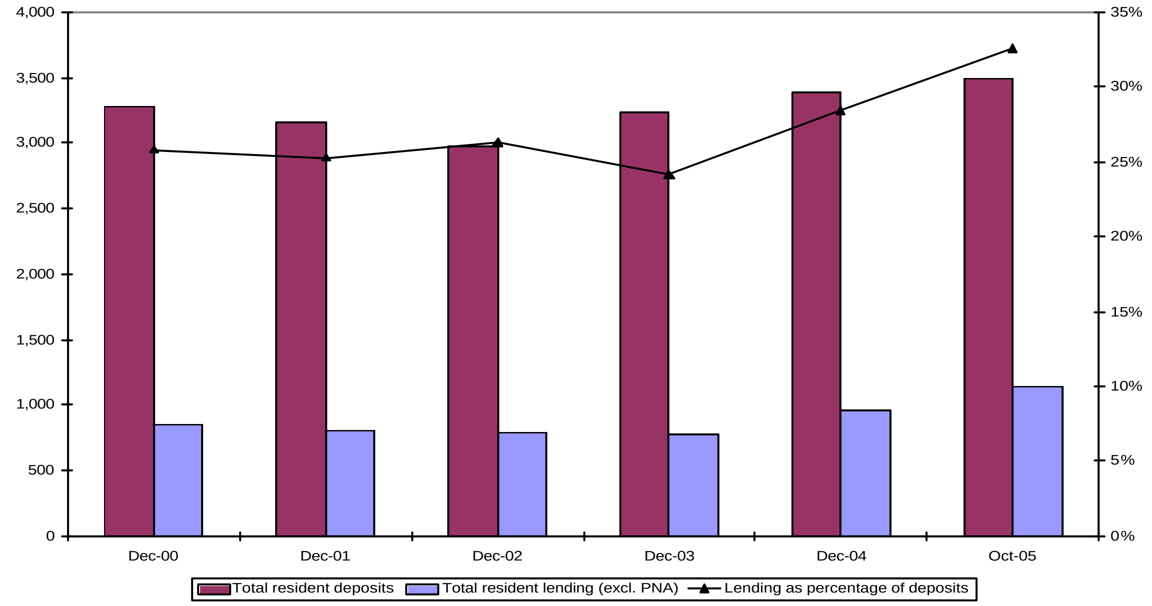
Deposits outweigh credits by a significant amount. On average, bank credit facilities to resident customers amount to about 25-30 percent deposited funds by resident customers. In other countries this loan/deposit ratio is much higher: the average for the MENA region is 80 percent[10].

The majority of the deposits are placed with the large Jordanian banks. For instance at the end of October 2005 over USD 2 billion (!!) was placed in balances with banks abroad. This begs the questions whether incentives can be designed to make it more interesting for banks to invest their excess deposits locally. If only 10 percent of these excess deposits would be invested additionally in the Palestinian economy, over USD 200 million would be available instantly. The KfW initiated European Palestinian Credit Guarantee Facility is such an incentive, decreasing the (perceived) risk of making loans to local small businesses. The team's proposed Guarantee Facility for bank loans to MFIs in Chapter 5 is another example of creating incentives for banks to lend locally.

Already before the Intifada, banks mitigated high (perceived) credit risk by lending short term and applying restrictive collateral requirements. Although the PMA has a loan/deposit target of 40 percent, this 'rule' was never really enforced. With hindsight the banks' conservative attitude has contributed to the relative quick recovery of the banking system from the early impact of the Intifada. However today, at least USD 600 million of total lending is at risk: USD 438 million in non-guaranteed loans to PNA and USD 200 million in estimated outstanding consumer loans. These latter loans are however provisioned for as PMA has tightened its guidelines on provisioning of such loans.

[10] Source: KfW – Study for a Micro and Small Business Finance Program in West Bank and Gaza, 2004

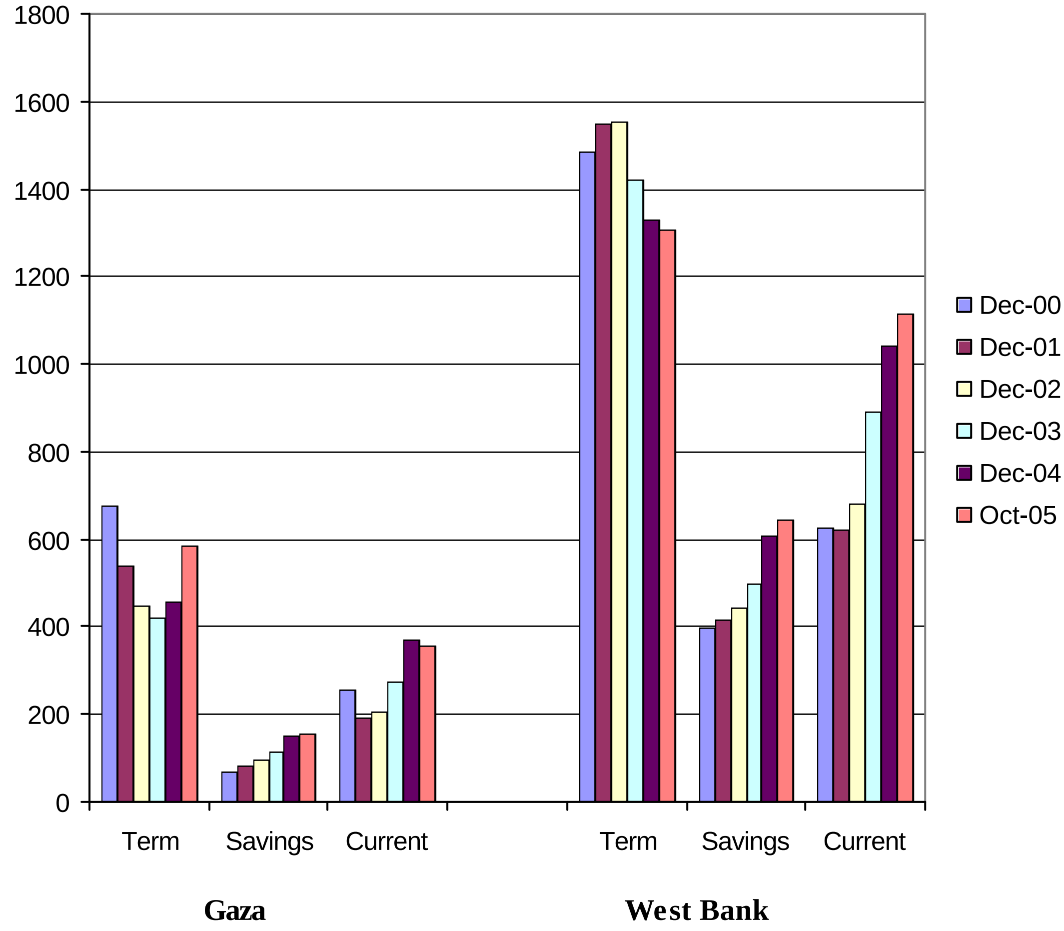
Graph 7: Loan/Deposit Ratio Development



The banks together have 187, 000 credit accounts: (i) overdrafts (54,000); (ii) loans (109,000) and letters of credit etc. (24,000). The PMA does not make a distinction between corporate and retail credit accounts. It is expected that a substantial part of the number of loan accounts are consumer loans to government employees.

Deposits. While overall total deposits and savings remained throughout the Intifada at a relatively stable USD 4 billion, term deposits experienced a sharp decline as is shown on the next page. As noted earlier, the majority of the deposits is placed with banks in Jordan.

Graph 8: Break down of term, savings and current account volumes (in USD million) in West Bank and Gaza



There are 824,000 current account holders : (i) accounts in JD 162,000; (ii) accounts in USD 241,000; and (iii) accounts in NIS 421,000. As is the case with credit accounts, no split is available in corporate and retail accounts.

The Emergence of Islamic Banks

Several Islamic banks have emerged. Today, their total combined assets comprise about 6 - 10 percent of all banks' assets. The Islamic banks clearly fill a gap: over 25 percent of businesses that need loans prefer to take Islamic loans[11]. Donors or other financiers wishing to cooperate with Islamic banks have to provide their funds to these banks also based on Islamic principles.

An important Islamic commitment is the denouncement of usury – the lending of money at exorbitant interest rates. In the pre-Islamic era, *riba*, literally translated as excess, referred to the practice of lending. Earning money through lending is considered *haram*, in discord with the *Sharia* (Islamic Code). Most Islamic finance organizations have tried to remove all forms of fixed nominal interest rates. But the abolishment of interest rates does not mean that no remuneration is paid on capital. To the contrary, profit making is acceptable. Islam deems profit, rather than interest, to be closer to its sense of morality and equity because earning profits inherently involves sharing risks and rewards.

[11] Source: ISAMI 2003

The three most common forms of Islamic finance are *mudaraba*, *murabaha* and *musharaka*. Under a *mudaraba* contract the financier provides the capital and the entrepreneur the labour and expertise. Profits and losses are shared at a pre-determined rate. This type of finance is appropriate for medium term investments in fixed assets or equipment. *Murabaha* is a common instrument for short-term financing based on the concept of buy-resell. Resell is done at costs plus mark-up. *Musharaka* is an equity participation contract in which two or more partners contribute to the capital and expertise of a project.

2.4.2 Past and Current Bank Engagement in Micro and Small Business Finance

Past Engagement

Three donors have funded for micro and small business finance are: (i) the WB/IFC Micro Enterprise Project (MEP – closed); (ii) the USAID bank micro finance program (closed); and (iii) the DEG Business Start-Up program (closed).

The IFC and USAID programs are described below. Although the WB/IFC project was called "micro", in effect it was designed for (very) small businesses as loan sizes could be as high as USD 30,000. Despite the differences between the two programs, the similarities were striking: (i) both programs expected the banks to put in their own funds for onlending i.e. putting their own money at risk; (ii) both programs provided intensive technical assistance to build sustainable capacity in the banks to engage in this type or lending; (iii) both programs were designed based on best practices; and (iv) both programs proved to be profitable for the banks (pre-Intifada) which may be the key litmus test.

The WB/IFC Micro Enterprise Project (MEP)

The project objectives were to: (i) to create jobs through the provision of medium term finance to very small businesses to rehabilitate and grow their businesses; and (ii) to develop capacity in commercial banks to engage in the type of lending in a sustainable i.e. profitable manner. The program started early 1999 and reached its peak in 2000.

IFC and IDA funds were lent to three commercial banks for onlending to very small businesses defined as enterprises with less than 10 employees. More important than the provision of funds for onlending, the critical component of the project was the Dutch and USAID funded intensive technical assistance program to assist the banks to build sustainable and profitable small business loan portfolios[12]. Profitability in this case is a function of low transactions costs, high collection rates and a correct pricing of the loans. The MEP adapted in an innovative manner techniques learned from best practice micro finance to help the banks to reduce transactions costs and risks such as:

- Decentralization of loan decision-making;
- Using evaluation criteria that are cash-flow and character-based rather than asset and document-based;
- Developing ongoing client relationships and intimate industry knowledge combined with the implementation of loans screening and monitoring systems as well as client-tracking systems;

[12] The technical assistance was provided by three different international microfinance consulting firms as the banks refused to accept being assisted by one and the same firm because of competitive reasons.

- Making loan officers responsible for both loan granting as well as collection of repayments, remunerating them on the basis of their performance in these areas; and
- Setting interest rates and fees that reflect the costs and risks appropriately.

The partner banks in the project were: Arab bank, the Commercial Bank of Palestine and Jordan National Bank. The three banks in effect got a soft loan of USD 12.5 million (USD 5 million IDA loan at 1.25%, and USD 7.5 million IFC loan at LIBOR plus). In addition banks put in USD 7.5 million of their own funds. In return for the "soft" loan banks had to contractually agree to implement small business finance best practices including the following: (i) appointment of dedicated loan officers responsible for loan screening as well as monitoring; (ii) cash flow based loan application evaluation; (iii) performance based reward systems. Banks were not allowed to use guarantee facilities (if offered) or credit-insurance.

Two types of loans were made: working capital loans of up to USD 10,000 and investment capital loans of up to USD 30,000. As of December 31, 2001, approximately 1119 loans were approved worth USD 12.5 million. USD 11.9 million was disbursed to 1,045 projects. The pre-Intifada estimates of total number of new jobs created under the project if fully disbursed, were 3,400 jobs.

The USAID Bank Microfinance Project

USAID has completed a micro-finance program with Arab Bank and Bank of Jordan (BoJ). The program started in the spring of 1998 and ended in December 2000. These two banks were selected based on their outreach potential (high number of branches) and their commitment to the program. Both banks put in all the loans funds in return for technical assistance by USAID: loan officer training; MIS; exposure visits etc.. USAID also initially paid the salaries of the loan officers on the condition that loan officers would work dedicated on the program. By doing so USAID could also pay performance based bonuses.

Table 4. Key Data USAID Microfinance Program

	Bank of Jordan	**Arab Bank**
Cum. # of loans	4,369	2,905
Cum. Value of loans	9,713,000	7,346,000
Average loan size	2223	2528
Cum. # male borrowers	4,168	2,532
Cum. # female borrowers	201	148
Cum. Value of loans to men	8,242,000	6,594,000
Cum. Value of loans to women	290,000	365,000
Outstanding balance 01/01/01	1,257,000	1,631,000
Outstanding balance 12/31/01	978,408	551,627
Repayment Rate	77%	94%
Financial Sustainability	>100%	>100%

The Bank of Jordan performed less well under the program than Arab Bank. This is reflected by the low repayment rate and appears to be due to lack of top management commitment. Nowadays the bank appears to be more seriously interested in microfinance and has for instance indicated to the recent CGAP mission that it wants to re-vitalize its microfinance activities.

Some of the initial lessons learned on the USAID banks' micro lending program are: (i) financially sustainable and profitable micro lending programs in banks can be implemented; (ii) micro lending skills and systems to manage micro lending portfolios in an appropriate manner can be developed. It is regrettable that USAID did not continue this successful effort in bank microfinance. As the Banque du Caire example in Egypt shows, potentially such a program could have reached thousands of clients and could have become a core business of the participating banks.

Box 4: Bank Engagement in Microfinance – the Example of Banque du Caire

In 2000 Egypt's financial sector, which is dominated by state-owned banks, faced yet another near crisis. A $600 million World Bank/IMF assistance package was needed to enable the government to bail out again some bad performing banks. Since then the government has stood firm in its commitment to stop rescuing bad performing banks.

Banque du Caire's successful venture into microfinance might not have occurred if there had not been a high-level political commitment to improve the health of Egypt's banking sector. Top-management of the four state-owned banks, including that of Banque du Caire, was replaced by high-caliber banking professionals who often had gained substantial experience abroad. These managers were given a clear mandate: improve the financial position of the bank (or else…). Moreover, government pressure on these banks to make loans to bad-performing state-owned enterprises also substantially decreased.

Banque du Caire had to make money in order to fulfill its new mandate. First of all this meant cutting costs, re-engineering the bank's internal operations, and making better use of its hundreds of substantially underemployed staff. Making money also meant increasing revenue and lending to ill-performing state-owned enterprises would not do that job. New target groups were sought.

With the financial support of USAID and the technical assistance of the well-known consulting firm EQI, Banque du Caire engaged in microfinance. The formula was straightforward: training, incentives, and marketing. Underemployed staff working in the 97 branches were invited to join the microlending program and become dedicated loan officers. They were trained extensively and, once active as microloan officers, received substantial bonuses based on performance. Bonuses could be as high as one-third of base salary.

Many staff volunteered for this career option: over 660 by year-end 2003. They feel a sense of accomplishment having shifted from being nonproductive employees to being highly productive persons who are also appreciated, notably by top management who have shown clear commitment to and keen interest in the program. The criteria for evaluation and appraisal of loan officers are highly transparent, which is quite a departure from past experience.

In two and a half years, Banque du Caire has reached over 45,000 active clients and a portfolio outstanding of over $14 million. The portfolio at risk (over 30 days) is less than half a percent. The client retention rate is on the low side but improving, indicating better responsiveness to client needs. Banque du Caire confirms that the profitability of its microloan portfolio is more than double the profitability of a normal performing loan portfolio in the best-performing banks.

No external guarantees were used. The bank used its own funds for onlending and no external guarantees were used. The bank also pays the loan officers' salaries and bonuses. The technical assistance package cost a bit more than $1.1 million, or 2 cents per dollar disbursed, which is very much in line with other downscaling programs observed in the world.

Current Engagement

With the exception of Alrafah bank – which has yet to make its first loan – and the microfinance program implemented by the Bank of Palestine on which there was no information available, there is no bank engagement in microfinance today. Banks state that under the current circumstances they are not prepared to invest their own resources in microfinance (as they do not believe that the clients would be able to repay) but would be prepared to channel donor funds to micro businesses provided they would bear no risk and receive a fee for doing so.

In effect, reality on the ground during the mission shows that some banks are instrumental to a decrease in access to finance for private individuals and businesses. Apart from the issue of the salary transfer to over 150,000 government employees, (Jordanian) banks have taken several measures – in the apparent context of anti-money-laundering measures[13] – that severely impact the Palestinian payment system and could grind it to a stand-still:

- *Restrictions on cash deposits*. Only the account holder (or direct family in the first degree) can deposit funds on his/her account. It is a common practice for Palestinians to do cash deposits on other people's account. For instance a cousin cannot deposit funds anymore in the account of his aunt who needs funds.

  This new regulation had an immediate impact on some MFIs as their borrowers do cash repayments in the MFIs bank account in the bank branch. For now, they managed to convince the banks to exempt the borrowers' repayments from the new regulation. Strict enforcement of this regulation would overnight result in loan portfolio quality problems for the MFIs and severe lack of access to finance of the Palestinian people as a whole.

- *Restrictions on the use of endorsed cheques*. Endorsed cheques are a commonly accepted means of payment in the West Bank and Gaza. New (Jordanian) banks regulations however stipulate that an endorsed cheque can only be cashed in by the person/organisation to which it is endorsed. Although this regulation will not affect MFI practices where borrowers repay using endorsed cheques to the MFI, it will affect the cash flow of the MFI clients and other businesses.

2.4.3 Alrafah Bank

Alrafah Bank was established by a group of prominent business people (see Annex 1 for Overview of Founding Members). The goal of Alrafah bank is to become the first full service microfinance provider in the West Bank and Gaza with operations in all cities and towns. The official opening of Alrafah Bank was on Sunday April 30, 2006. The bank has for now one branch in its head office. A second branch is expected to be opened in Gaza city in June 2006. Currently the bank has 52 staff of whom 15 are loan officer.

While the minimum capital for a bank required by the PMA is USD 20 million, the paid – in capital of the bank is USD 30 million. USD 12.25 million is contributed by the founding members, while USD 17,75 million has been obtained through a limited public offering. The public offering was over-subscribed: the USD 17.75 million available (17,550,000 shares of USD 1 each) were subscribed for USD 82 million. The bank allocated pro-rata to the 19,000 subscribers. 14,600 subscribers received each about 700 shares (worth USD 10,2 million) while the remaining 4,400 subscribers received a higher amount of shares. Some of these latter shareholders are related to the Founding shareholders, ensuring voting

[13] It must be noted though that these regulations are not implemented in Jordan.

majority. The bank considers the high number of small shareholders as a sign of confidence in the Founding members of the Bank.

The statutes of the bank ensure that the only Founding Members (15) of the Bank can be Board members (9) for the first 4 years to ensure strategic guidance. After this period Board Members shall be elected from the General Assembly of shareholders.

The IFC has financed some (limited) technical assistance worth about USD 40,000 to the bank including: (i) a review of the bank's business and action plan; (ii) help with drafting job descriptions of the key management positions; and (iii) review of and help with development of MIS system. Up to now the CEO of the bank has obtained all the know-how through a variety of mixed sources, notably from the internet.

IFC has also financed a market study to be implemented by PlanetFinance, which will be made available to the whole microfinance sector in the West Bank and Gaza.

IFC is considering a 10 percent equity stake but will engage in due diligence only when the current political situation stabilized. While IFC in other countries has taken higher equity stakes in microfinance banks (up to 25 percent), PMA regulations prescribe that no single shareholder (and affiliates) shall have more than 10 percent ownership of a bank[14].

Using extensive credit scoring models and seeking a variety of guarantees, the bank plans to offer a variety of loan products such as: (i) investment loans (up to USD 10,000 for group members, and up to USD 20,000 for individual loans with a maximum maturity of 36 months; (ii) working capital loans for existing micro businesses of up to USD 10,000; (iii) housing loans, mainly in rural areas up to USD 10,000; (iv) consumption loans – called 'life improvement' loans of up to USD 10,000 with a maturity of up to 24 months; (v) possible 'health' loans in cooperation with Ministry of Health; (vi) 'special occasion loans' of up to USD 1,000 for a period of 6 months; and (vii) 'emergency loans' of up to USD 3,000 for a period of up to 6 months.

Projections and Needs
The Bank plans to reach 50,000 borrowers by the end of its fifth year of operations (i.e., Mid-2011). It expects to have USD 100 million in loans outstanding then[15]. This is under the 'Normal Intifada' scenario. The Bank has no emergency case scenario but intends to amend its business plan accordingly should such a scenario evolve.

The bank has a variety of needs in the area of funding and capacity building. The CEO acknowledges that the bank does not really need funding for capacity building as it can obtain such services from its own recourses. However the CEO does need help in determining which services are appropriate and valuable to the bank and which ones not. Overall, more focused long-term technical assistance in managing and growing a microfinance bank would contribute to the bank's potential for success.

[14] The PMA however has already made one exception regarding Al Rafah Bank: the Nasir Eldin Group has obtained permission to own 11.33 percent.
[15] It is expected that up to 7,000 clients could be reached in the first year of operations, 50% in micro business and 50% in retail (consumers).

Guarantees

- Guarantees: the CEO states that (partial) risk sharing – on a declining basis - is an urgent need, especially in agricultural finance. The bank has approached the KfW initiated EP-CGF but has been for now rejected as one of the conditions for bank participation in the CGF is that the bank has a track record. The bank would also be interested in donor (grant) co-financing with the donor taking the first loss.
- The bank also is interested in lending to MFIs for onlending but would also seek guarantees for such a loan.

Tentative Evaluation

As the bank yet has to make its first loan, it is difficult to evaluate and assess the impact of Alrafah bank on the Palestinian Microfinance Sector. A few remarks could be worthwhile noting:

- The extensive credit scoring models that the bank will use with the available guarantees constituting a major element in the loan decision making, indicate that the bank may not yet fully grasp that an essential element of banking is risk taking and risk management. This view is even more confirmed by the fact that the bank is actively seeking also donor funded guarantees for its lending. Targeting micro and small businesses however means taking calculated risk and pricing accordingly.

- It remains to be seen how committed the Board will be to the target group and the inherent social-commercial objective of the bank. Such target group commitment would entail that the Board has a long-term strategic view and would be willing to forego short term gains in order to reach long term sustainability.

- Potentially – in the short term – the bank could become a 'political' instrument as many Board members have strong relations with the former government. A microfinance bank has to charge high interest rates in order to cover its costs and risks and it remains to be seen whether the Board will be willing to do so under the current political circumstances.

The success of other so-called 'Greenfield' banks around the world – and notably the ProCredit Bank Network[16] - shows that target group oriented banks could be profitable and reach thousands of clients with a full range of financial services of which credit is just one (see Annex 2 for key loan statistics of the ProCredit Banks). Key success factors for a Greenfield bank include: (i) committed shareholders with a long-term social-economic objective; (ii) pro-active savings mobilization right from the start; and (iii) an able and experienced management services company that would manage the bank and also have an equity stake in the bank.

Were Alrafah to be successful – and would it meet the above mentioned conditions for success – it could potentially have a great impact on the microfinance sector in the West Bank and Gaza. It would be possible then that Alrafah could compete some MFIs out of the market, especially those that offer credit products that are currently also offered by regular banks. In other small countries such as Kosovo or Bosnia, where Greenfield banks

[16] www.procredit-holding.com

were established, the remaining MFIs 'went back to their roots' serving those clients, especially women needing group loans – that were not fully served by the Greenfield bank.

2.4.3 Savings and Deposits

The success story of the savings and credit cooperatives shows that there is a need for savings services. Poor people can and do save: they sometimes save informally in groups, or store their excess liquidity in assets such as gold (jewellery such as wedding ring, golden teeth etc.). However storing savings in such assets has disadvantages: (i) the assets are not always safe (risk of theft etc.); (ii) transformation of the assets into liquidity is not always easy and often expensive; and (iii) systemic risk of obtaining a low cash value for the assets in a situation that many want to sell their assets at the same time.

Not only PlanetFinance (with IFC funding) but also the UK Department for International Development (DFID) are planning to implement microfinance demand studies in the West Bank and Gaza. Both will include the demand for savings and deposit services. As it is not known to what extent the poor have already depleted their savings during the Intifada, it is expected that these studies would confirm and quantify the need for savings services.

The provision of savings as a convenient, reliable service is currently not offered in the West Bank and Gaza. Banks have high minimum amount requirements and the poor often distrust the banks. Annex 4 shows an overview of the terms and conditions for opening and maintaining savings accounts, term accounts and current accounts of 7 selected banks operating in the West Bank and Gaza.

To open a current account, banks require a person to have a minimum ranging from USD 200 to USD 500. Only the bank of Jordan has a very low minimum: USD 20. The minima required to open a savings account are usually lower and range around USD 100. It must be noted though that a person *must* have a current account in order to be able to open a savings account. The minimum requirements for term accounts appear very high: most banks require at least USD 5000 and some banks require even USD 10,000 as a minimum. Only the Bank of Jordan has a 'low' minimum: USD 1000.

MFIs legally are not allowed to take savings. The box below shows that this may be an appropriate legislation in the current Palestinian context.

Box 5: When Should a Microfinance Institution Mobilize Savings from the Public[17]?

As a source of commercial finance for microcredit institutions, voluntary savings and deposits have generated a lot of interest in recent years. Locally mobilized voluntary savings are potentially the largest and most immediately available source of finance for microcredit institutions. Mobilizing such savings also helps meet the vast unmet demand for local savings services.

Three conditions should be met before a microcredit institution starts mobilizing savings. First, profitable mobilization requires an enabling macroeconomy, an appropriate legal and regulatory environment, political stability, and suitable demographics.

[17] Source: 'Introducing Savings in Microcredit Institutions: When and How?'- CGAP Focus Note 8, 1997

The second consideration concerns the supervision of institutions providing microfinance. To protect their clients, especially depositors, financial institutions that mobilize savings should be under government supervision. This, of course, requires a government that is willing to modify its banking supervision system so that the rules for microcredit institutions are appropriate for their activities, and to ensure that the supervisory body is able to monitor these institutions effectively.

The third consideration concerns the history, capability, and performance of the microcredit institution. Before mobilizing voluntary public savings, a microcredit institution should have demonstrated consistently good management of its own funds. It should be financially solvent, maintain a high rate of loan recovery, and earn attractive returns. A good track record is important because in many countries low-income people have entrusted their savings to small, unsupervised financial institutions, only to lose their life savings.

Once these three conditions have been met, the microcredit institution could carefully consider how to mobilize voluntary savings.

The team recommends that MFIs in the West Bank and Gaza should not mobilize savings. Savings are a source of funds but MFIs could also access bank loans for onlending. In the context of savings as a service, MFIs could link up with banks and be an intermediary/facilitator in the provision of savings services. They could offer these services to existing clients – many of whom are already familiar with banks as the majority of clients do their repayments in a branch of a bank[18]. There may also be a large untapped market among poor who do not wish to borrow but who do wish to save.

[18] In the past, some MFIs had loan officers collecting repayments and depositing these in the bank. This however was not a secure operation and also open for fraud. Hence, the majority of clients deposits the repayment in the bank herself.

3. Where are we now: State of the Industry

3.1 Key Issues Faced by the Sector

3.1.1 Legal issues

The different MFIs face different legal issues depending on their legal and institutional set-up.

Microfinance Programs that are part of a larger (more socially oriented) organisation
These include: (i) the Microfinance and Microenterprise Program (MMP) in UNRWA, an UN organization; (ii) the HILP/PEOPLED program in CHF, an international NGO; and (iii) the microfinance program based in ANERA, an international NGO.

In order to ensure financial autonomy as well as institutional and legal sustainability, these microfinance programs based in larger socially oriented organisations should be spun-off into independent locally registered and managed organisations such as NGO, company, or registered microfinance institution, should such a legal form be deemed necessary in the West Bank and Gaza[19]. Another, more conceptual argument for spin off or separation is the fact that the 'mother-organisations' are considered relief organisations and are assumed not to be around indefinitely.

Microfinance Programs registered as Local NGO under the Ministry of Interior
The three NGOs concerned are: (i) ACAD; (ii) ASALA; and (iii) YMCA. These NGOs are formed under the Law of Charitable Organisations and Community Organisations (Law on NGOs) and are registered at and overseen by the Ministry of Interior (MoI). Board members are elected from a General Assembly. Some NGO MFIs have the same number of Board Members as General Assembly Members while others have a larger General Assembly.

The CGAP January 2006 study[20] quotes the following issues faced by NGO MFIs. "First, they are overseen by the MoI which is not the appropriate body to be regulating an organization engaged in a financial business. Second, the Law requires that all legal documents, including cheques be signed by the Chairman of the Board. Although it is possible to delegate signature authority by means of a proxy, the MoI generally does not approve such proxies in practice. This restriction is extremely limiting for the efficient operation of any MFI, especially for those with clients in multiple locations. Speedy loan disbursement, which is a critical concern for a microfinance client, is compromised when cheque signing is centralized. Furthermore, the centralization of legal authority in the position of the Chairman poses a heavy burden on the Chairman who by Law may not be compensated. Third, NGOs, by definition, are not allowed to raise equity from investors. Any increase in balance sheet equity is limited to retained earnings and grant funds received from donors. For these reasons it is unlikely that NGO MFIs will be able to

[19] A CGAP team evaluated the MMP program of UNRWA in 1996 and one of the key recommendation already at that time was to take the microfinance operations out of UNRWA. At that time the management of the microfinance staff was not free to hire and fire staff and to implement loan officer incentive systems which are essential to loan officer performance and loan portfolio quality. The management of the microfinance program used the CGAP recommendations to ensure managerial freedom in these two areas which made the need for spin off at that time less urgent.

[20] CGAP "Meeting the Demand for Microfinance in the West Bank and Gaza"; Xavier Reille, Mohammed Khaled and Kate Lauer, January 2006.

expand operations significantly, which would be necessary, if these MFIs together would want to meet the demand for microfinance services".

The Minister of Economy of the previous government has expressed his willingness to re-register the three NGOs with the Ministry of Economy. Discussion with the three NGO MFIs reveal that they were keen to do so. It remains to be seen however whether such re-registration would solve the issues raised above.

Microfinance Institutions registered as Company
Two MFIs are registered as company. One of those MFIs, FATEN, is currently registered at the Ministry of Economy as a Not-for-Profit Company under the Gaza Companies Law. The West Bank Companies Law has repealed its provisions on non-profit companies. Assuming that the Palestinian Authority will continue to harmonize the different Laws and Regulations in Gaza and the West Bank, it remains to be seen how sustainable FATEN's legal status would be.

Cooperatives
The CGAP study states that "all cooperatives, including savings and credit cooperatives, are currently registered with and regulated by the Ministry of Labour, the Ministry also responsible for overseeing non-financial cooperatives". The issues presented by savings and credit cooperatives can be quite different from the other types of cooperatives, especially given the risks and responsibilities associated with taking members' savings. In other countries the trend is to impose some prudential regulation (although not to the extent of typical banking regulations as cooperatives usually do not take savings from the *public*), and to assure that the regulatory body has the requisite expertise to execute prudential regulation effectively".

3.1.2 Governance Issues: The Need for Strengthening the Legal Framework

Microfinance best practices suggest that regulation and supervision only become important once MFIs start taking savings and deposits i.e., other poor people's money.

However, experience in the region as well as in Palestine, suggest that there may be more reasons to regulate the sector. These include: (i) lack of clear legal enforcement of the fiduciary responsibility of Board members; and (ii) lack of legal means to prevent Board members from interfering in day-to-day operations.

Laws and regulations do not provide clear and transparent options to hold Board members of NGO MFIs (and also non-for-profit MFIs) accountable (and liable) for their actions. Although they usually have some kind of 'fiduciary' or '' trustee' type of responsibility for the – sometimes - millions of donors funds put into the MFI as capital, in practice they 'could take the money and run' and there would not be an appropriate legal recourse to stop them doing so. Some MFIs have tried to address this issue by giving the donor organisation that originally funded the MFI a seat on the Board (sometimes with a veto vote). In practice, representatives of such organisations are not active and do not engage in board meetings. Also, depending on the former (international) donor for governance is not a sustainable solution.

Despite the fact that the Statutes of a NGO MFI (or Company MFI) usually limit the powers of a Board to guidance on strategic mission and vision, approval of business plan and budget, as well as hiring and firing the manager of the MFI, in practice Board members often interfere in day-to-day operations. The manager can try to stop such interference but eventually his position is at risk. Examples in the region are known where Boards in effect have high-jacked the MFIs.

The issues described above suggest that – even when MFIs do not take deposits and savings – the existing legal framework governing NGOs (and companies) should be strengthened to ensure that all parties (Board and Management) adhere to agreements made in the By-laws when setting up the MFI.

Holding Board members accountable to uphold the By-laws also would mean putting some minimum criteria on their skills and experience (comparable to criteria enforced by Central Banks around the world on education, skills and experience of Board members and key managerial staff). As a consequence the practice not to compensate Board members may also have to be reviewed. Finally Board members require training and manuals for such training should be developed.

3.1.3 Grant dependency

The Palestinian microfinance sector is fully dependent on grants from donors for loan capital and in many cases also (partial) operational cost coverage. Only one MFI, ASALA, has recently concluded an agreement with the Dutch Cordaid for a four-year soft-loan.

CGAP estimates that over the past 10 years over USD 50 million has been invested in the microfinance sector in loan funds and capacity building. USAID indicated to CGAP that it had approximately put in USD 30 million, making it the primary donor in the West Bank and Gaza.

Year end 2005, the aggregate loan portfolio outstanding was USD 38 million, which is basically funded by donor grants. Hence USD 12 million remains as estimate for past investment in capacity building. This would be USD 1,000 per active client y/e 2005[21], or 30 cents per dollar outstanding.

Pollock estimates that since the inception of the Palestinian microfinance sector over 170,000 loans have been disbursed with a cumulative amount of USD 180 million[22]. Investment in capacity building then would be USD 70 for each loan disbursed (or 6 cent per cumulative disbursement volume).

The abundance of available grant funding in effect has hindered the development of the sector towards a more commercial orientation. Anecdotal evidence suggest that some MFIs have refused attractive offers of soft loans from donors because of the availability of grant funds.

[21] If we would exclude the recent influx of USD 8 million for housing finance through CHF and FATEN, from the aggregate loan portfolio, an estimated USD 20 million would have been spent on capacity building, approximately USD 1,800 per active client, or 40 cents per dollar outstanding.

[22] UNRWA Microfinance Note prepared for the US Special Envoy for Gaza, JW Wolfensohn, June 2005.

3.1.4 Client responsiveness and Market Fit

Although the sector as a whole has introduced new loan products (such as housing and consumer loans), the MFIs offer similar products: group loans, very small micro loans, somewhat larger micro loans, so-called ‘fast’ loans for special occasions for good clients, as well as the above mentioned housing and consumer loans. MFIs tend to have similar terms and conditions and tend to compete on price. Competition based on product quality or product design appears to be absent. It appears sometimes that MFIs try to fit the client into the loan product in stead of tailoring the product design to the client’s needs.

Given the limited size of the market, tailor-made products for instance at the sub-sector level could enhance the competitive position of a MFI. Adapting for instance the repayment schedule of a loan product to the cash flow dynamics of a sub-sector – such as instance olive oil processing or cherry tomato cultivation – could benefit both the client and the MFI.

The lack of creative (loan) product design tailored to the needs of groups of clients may stem from the fact that MFIs routinely do not engage in impact assessment or demand surveys. A more mature sector would consider this a standard procedure. The initiative of PlanetFinance to help MFIs do impact assessment studies (and integrate such procedures in normal operations) is hopeful.

Most MFIs also offer certain loan products that are similarly offered by banks with the same terms and conditions such as pricing and the use of salary guarantees. It is acknowledged that the market is limited but it remains to be seen whether scarce donor money should be used to provide loan products to target groups that banks serve out of their own funds.

3.1.5 The Mantra of Sustainability – at what price?

The MFIs included in the sector assessment are all keenly aware of operational sustainability: the ability to cover all operational costs (including loan provisioning) out of interest and fee income. They all fiercely want to protect their (donated) cheap capital base as this is their only source of funds for onlending.

It appears though that operational sustainability (or OSS operational self-sufficiency as it is called in the West Bank and Gaza) has become an objective in itself and not a means to achieve (financial) independence from donor funds and reach an ever increasing number of clients. The vision is to become operationally sustainable but a clear strategy on market position, niche or value added vis-à-vis competition appears to be lacking.

Genuine sustainability requires profitability even after financing costs and inflation have been accounted for. This concept is less well understood by the MFIs in the West Bank and Gaza and often not even measured.

The mantra of operational sustainability has some – undesired for – consequences, which appear to be ‘indulged’ by most donors without understanding the underlying factors (such as yields):

- Some MFIs expecting (and getting) grant funding for investments in human resources such as training, as paying for this out of their own income would affect sustainability (i.e., higher costs and hence lower OSS). Investment in human resources should be a normal operational cost. One mature and operationally sustainable MFI even asked for funding for cars, which is also normal operational cost.
- Some MFIs expecting (and getting) grant funding for branch expansion as investment in branches – a normal investment to increase outreach – would affect the OSS negatively.
- Some MFIs turning down soft loan offers as it would affect OSS because interest expenses would be incurred. If MFIs would use the FSS as benchmark indicator of their performance, any soft loan would be welcomed as long as its price is below the imputed costs of funds.
- Some MFIs not using a general provision on the performing part of their loan portfolio (as it would negatively impact OSS) while this is even in non-conflict environments a normal procedure and even more important in high-risk environments like the West Bank and Gaza.
- Some MFIs becoming (single) donor dependent and as a result accepting donor initiated projects or programmes without fully considering whether such program would fit the MFIs strategy of would affect the MFIs performance and image. The donor dependence makes the MFIs vulnerable to political influences.

3.1.6 The Emerging Humanitarian Crisis – Emergency Case Scenario

Before the start of the fieldwork USAID requested the team to include in its new activity design an emergency case scenario as USAID and other donors were expecting a humanitarian disaster to evolve with the continued freeze on salary payments to government employees and the reduction/suspension of donor funding to and through the new government.

The team asked each MFI visited for its projections under a so-called emergency scenario. The team used the World Bank's scenario number IV as guideline in its discussions with the MFIs[23]: the situation would deteriorate, with increased trade and labour restrictions and suspension of revenue transfers, reduced aid-flows, resulting in substantial increase in poverty and unemployment Poverty would increase to 74 percent in 2008 and unemployment to 47 percent. GDI per capita will be decrease from USD 1,657 (estimated year end 2005) to USD 1,020 in 2008.

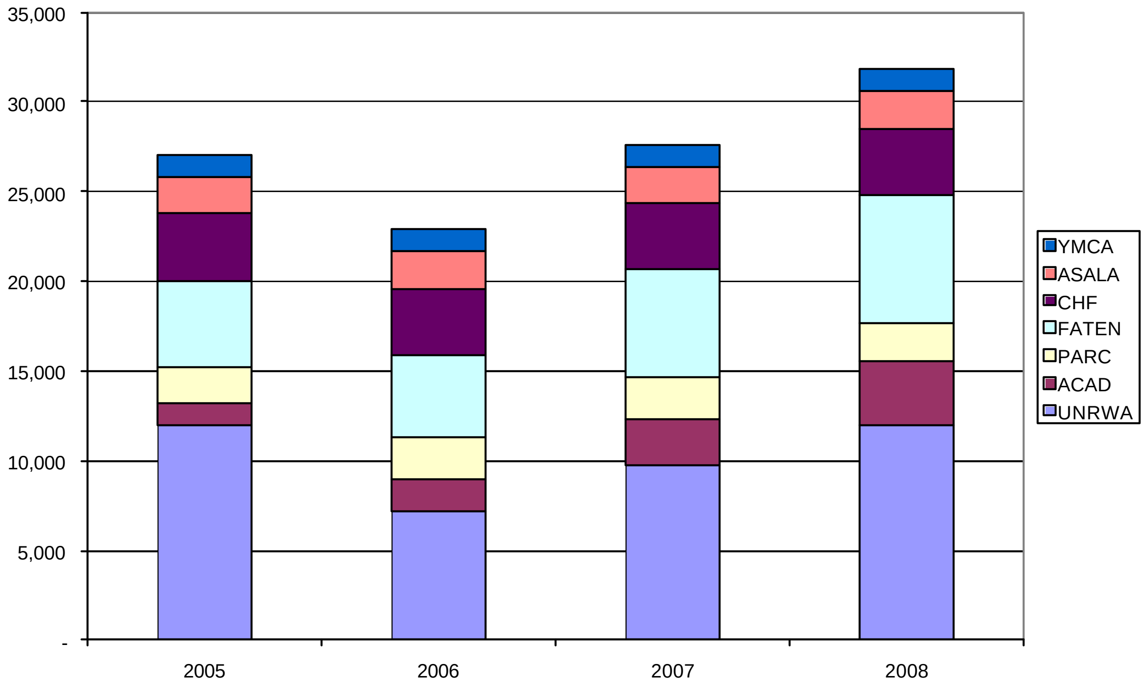
Mid-April, the United Nations published a scenario for the immediate future that was worse than the World Bank's worst case scenario described above[24]. Early May 2006, the World Bank admitted that its worst case scenario had been 'too rosy'[25].

Overall the MFIs appeared to be ill-prepared for the emerging humanitarian crisis. They appeared not to have thought through the consequences and – as is shown in graph 7 - were expecting a similar 'dip' in their number of active clients as the one resulting from the April 2002 invasion. The MFIs were also not in similar state of panic as the donor

[23] World Bank Economic Update and Potential Outlook – March 15, 2006.
[24] Assessment of the future humanitarian risk in the occupied Palestinian Territory – UN – April 11, 2006.
[25] The Palestinian Fiscal Crises – World Bank – May 7, 2006.

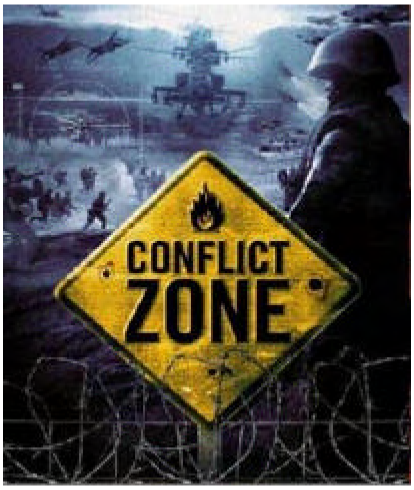
community – and appeared quite confident that they could handle the expected crisis as they had done so in the past. It must be noted though that several MFIs had already stopped making new loans or had substantially reduced lending already, especially salary-guaranteed loans. One MFI – CHF – had developed an emergency plan as well as concepts for emergency loan products.

Graph 9: Projections Number of Active Clients under Emergency Case Scenario



When asked about their needs in an emergency scenario, most MFIs requested coverage of loan losses and/or operational deficits. Given the 'mantra of sustainability' this should not come as a surprise. Most of the MFIs appeared not have considered the (humanitarian) needs of their clients. However the mission triggered heated debate on the need for grants versus loans in a situation of crisis and the team's proposed emergency case new activity design in the following chapter reflects the outcome of this debate.

4. New Activity under Emergency Case: Microfinance in the Wake of Conflict: Relief *vs.* Credit



4.1 Consequences of Conflict

"The only thing worth doing is to live in peace and cultivate our gardens."

Former U.S. Secretary of Defense William Perry, The Aspen Institute, 1995- quoting from Voltaire's Candide

The above statement illustrates the importance of proactive, carefully designed interventions in today's complex conflict environments. To act hastily or unwisely, Perry argued, could create unintended, potentially severe repercussions. To do nothing or to retreat could result in prolonged human suffering and the need for more extensive, costly, and difficult involvement down the road[26].

Microfinance professionals operating in conflict environments value the essence of careful and proactive handling of crisis situations. In conflict areas where risk is unavoidable, an increasing number of donors and practitioners initiate and continue microfinance activities for various reasons[27]:

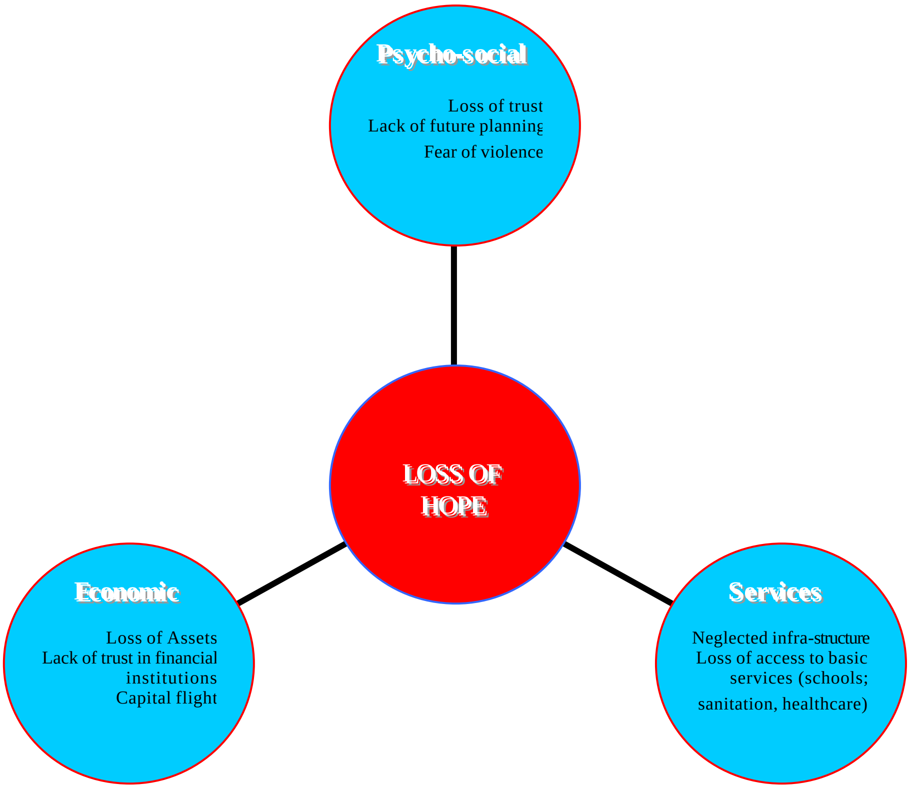
- Partly, they may be driven by the opportunity to deliver products and services during a period when demand is high and no other options exist.

- Some belief that microfinance presents a more sustainable and client-responsive option than does continued humanitarian assistance.

[26] Karen Doyle, *Microfinance in the Wake of Conflict Challenges and Opportunities*, Microenterprise Best Practices, July 1998.
[27] Ibid

- For others, the chance to support economic activity and employment creation after months or years of stagnation and to curtail spiraling poverty and further marginalization of the poor are also major motivating factors.

***Graph 10:* CONSEQUENCES OF CONFLICT**



Conflict environments have debilitating consequences on development, As illustrated, the impact goes beyond the depletion of economic and institutional capital, to decreasing social capital through loss of trust, and the decline human capital through death, loss of self-esteem, and trauma.

In such situations, microfinance has been viewed as a multi-purpose tool. Whereas microfinance predominantly serves as an effective economic development strategy, there is also consideration of its use as a relief and survival strategy in the immediate wake of conflict.

Conflict strategies mirror normal microfinance strategies in many respects, but there are some key differences. In conflict situations, strategies — and the programs that carry out these strategies —tend to be implemented more flexibly to respond to changing circumstances. Focus is greater on mechanisms to build trust among clients who have suffered. Microfinance institutions may offer lower interest rates, grace periods, loan rescheduling, or other breaks building towards a state of normalcy.

4.2 Guiding Principles for Donor Interventions in Conflict Situations[28]

Apply good practices: Microfinance good practices do apply to conflict-affected situations. Core principles, such as maintaining high portfolio quality, applying market interest rates, and planning for full cost- recovery, should not be compromised. Donors and their partners must understand client needs and their capacity to use financial services. Providing credit to someone who cannot repay only creates greater vulnerability and insecurity.

In extreme cases of conflict where there is major loss of physical and financial assets, little or no business activity, and high client immobility (due to curfews and enclosures) grants may be the most appropriate relief instrument. However, experience from practice has shown that any mixing of grants and loans has always resulted in very poor repayment for the loans**.** This may destroy both the market and client discipline in the long term whenever a project involving any type of credit fails. The ability to apply best practices may be considered as a *litmus test* - if microfinance best practices cannot be applied, most likely microfinance is not the best development response.

Ensure separation between relief and financial services: Under conflict situations, it should be clear when and where to utilize grants for relief activities versus offering financial services. The line is drawn when mainstream microfinance practices may be difficult to implement and relief grants may be more helpful.

Collaborate with stakeholders: CGAP and the World Bank designed the Microfinance Investment Support Facility for Afghanistan (MISFA) to combine diverse donor funding (DFID, CIDA, USAID) and goals in a single, flexible funding and institution-building support mechanism. Over US $20 million has been invested following good practice performance and transparency standards, without all donors having microfinance expertise on the ground.

Be responsive to the local context: Volatile situations require donors to "tread carefully" and be sensitive to local issues. Donors should be ready and accepting to sometimes work in areas not controlled by governmental authorities

CHF International in Iraq *(with consent by USAID) negotiated with religious leaders in Iraq's southern holy cities to accommodate their concerns about foreign aid workers and to ensure the safety of their staff and partners.*

[28] CGAP/Direct: Guidelines for Donor Interventions in Conflict Situations, Presentation for Microfinance Donors, February 11, 2005

4.3 Emergency '*CredAid*' Program

4.3.1 When is microcredit an appropriate response?

For microcredit to be an appropriate poverty-alleviating, income-enhancing, socio-economic tool, a pre-existing level of on-going economic activity, entrepreneurial capacity and managerial talent is needed. If not, then clients may not be able to benefit from credit, and will simply be pushed into debt. In a crisis situation, with limiting paradigms, microfinance may not be the proper remedial tool. This may be true in situations such as[29]:

- In an emergency or immediate post-emergency environment;
- For the chronically destitute, credit is unlikely to succeed without pre-existing efforts to reduce vulnerability and to build skills, confidence, and a minimal financial base;
- In severely disadvantaged rural areas lacking infrastructure, services and/or access to markets.

Box 6: Reaching the Red Zone

With continued dramatic fiscal compression – or even partial solution to the fiscal problem - one or more of the following is expected to occur in the coming months[30]:

A Humanitarian Crisis - under the pressure of loss of income, demand factors are likely to manifest as well, and the need for humanitarian relief may rise steeply. The most serious pressure point will be Gaza, both because of the relative dependence on PA wages (almost 40 percent of those employed in the Gaza Strip work for the PA, earning almost twice what private sector employees do) and because of the Strip's dependence on a single supply passage which is subject to frequent closure. With a partial solution to the fiscal problem, the economy would still experience a dramatic decline over the coming eight months: by the end of 2006, average personal income would decrease by 30 percent in real terms, unemployment would increase from the pre-election figure of c. 23 percent to about 40 percent, and poverty levels would climb from 44 percent last year to 67 percent.

Rising Insecurity—Non-payment, part-payment or unequal payment of salaries could precipitate breakdowns in force discipline in the PA security services; in the past year there have been many instances of security personnel threatening or using force to pressure the PA on salary and benefits issues.

Institutional Dissolution— If the PA remains unpaid/minimally paid for several months, it may cease to function: civil servants have already begun to withdraw their services in protest, and this can be expected to intensify as personnel down tools and look for other ways to subsist. International experience in 'fragile states' contexts shows that mainstream institutional breakdown is very hard to reverse: complex structures such as school systems are not machines to be switched on and off at will[31].

[29] CGAP, Focus Note #20

[30] Source: World Bank Economic Update and Potential Outlook – March 15, 2006 and The Palestinian Fiscal Crisis' May 7, 2006.

[31] In primary and secondary education, the PA employs almost 36,000 staff (72 percent of all education personnel), runs 76 percent of all schools (1,679 of 2,209) and educates 70 percent of all school children. In health, 11,000 staff is employed to run 62 percent of all health facilities (800 of 1,290). These proportions are significantly more pronounced if refugee camps (in which UNRWA delivers such services) are excluded.

4.3.2 When should micro-grants be considered?

Micro-grants provide a safety net, and can be the first step in a strategy to graduate the poor from vulnerability towards economic self-sufficiency. Those hit by crisis may need a temporary safety net. The most vulnerable of this target group may be candidates for one-off, targeted "safety net" grants that enable them to rebuild their livelihoods and replace lost assets. Grant-based schemes may also provide a starting point to bring people to the level where they can make plans and consider investments at a later stage.

However, grant support can create long-term dependence and distort the market for microcredit. Below are guidelines to ensure that micro-grants complement, rather than crowd out, commercial financial services and productive investments.

Box 7: Guidelines for Micro-grants

Micro-grants should:

- Be very carefully targeted to those that microcredit cannot serve in a particular context;
- Be one-off, and include a "graduation" process to market-based mechanisms (mainstream microcredit services);
- Be carefully structured and monitored, to ensure that they are spent as intended;
- Be accompanied by training or mentoring, when grants are intended for productive purposes;
- Require a cash contribution of at least 5 to 10 percent of the grant value from the grant recipient;
- Not finance investments that result in income streams that could be used to repay a loan from a microfinance institution.

Source: CGAP/DIRECT, *Presentation for Microfinance Donors*, February 11, 2005

4.3.3. Grants versus Loans in the Palestinian Context

Successful responses to conflict require innovation and adaptation of microfinance best practices. In the case of the impending crisis situation in the West Bank and Gaza, the design of a relief package should be carefully implemented to mitigate against further industry decline post conflict. As discussed earlier in this paper, whereas cases have been established for the success of micro-grants as relief mechanisms, the meshing of grants and mainstream loans may create long term repercussions on the sustainability of the industry. The Palestinian microfinance industry necessitates another type of intervention for the following reasons:

- Size and Maturity of the Market: The microfinance industry in Palestine is relatively small. Any distortion may likely to bring the industry down. Additionally, the mature MFIs in Palestine have exerted tremendous effort to build a sound credit culture both internally and externally.

- Resistance by Implementing Institutions : The success of any relief package has to receive the seal of approval from all involved parties. The MFIs have clearly indicate that they are unwilling to partake in any relief effort that may carry the imprints of micro-grants as this will undermine the credit culture they have long striven to build.

- Conflict Nature: Although the imminent *new* crisis is expected to last up to 18 months, the general continuing crisis of enclosures, curfews, daily armed conflict, limited mobility and displacement is indefinite in nature. Any grant-relief approach may be perceived as a right by clients under the general crisis situation.

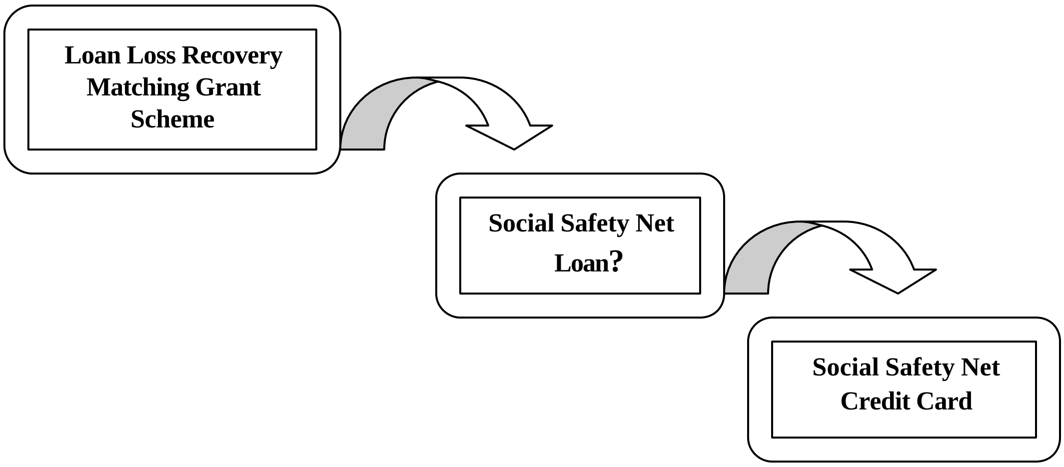
Building on the above reasons, the design of the *"CredAid"* package is based on a three-tiered approach. *"CredAid"* will serve three purposes:

- *Preserve* the physical and financial infrastructures of the microfinance institutions through a loan loss recovery matching grant scheme;

- *Provide short-term credit relief* for existing clients to minimize crisis impact on depletion of assets through a Social Safety Net Loan Program

- *Maintain* basic subsistence needs for MFI clients through the introduction of social safety net credit cards

THE *"CREDAID"* RELIEF PACKAGE



4.4 CredAid Program Description

4.4.1 First Tier: Loan Loss Recovery Matching Grant Scheme

Target Group: Microfinance Institutions (MFIs)

Purpose: Loan loss recovery and minimizing impact of asset depletion and large operating deficits

Methodology:

- USAID grants MFIs 50% of estimated operating costs to cushion off crisis impact and ensure institutional going-concern assumption
- MFIs would enforce their provisioning, loan loss and write-off policies
- MFIs would implement the write-off policies throughout crisis period (expected to exceed 10% of total outstanding portfolio)
- MFIs would continue to implement stringent loan loss recovery methods through direct follow-up and collection.
- USAID will match value of recovered losses

Assumptions:

- Write-offs are done after 180 days of default
- USAID will reimburse MFIs in two tranches:
    - 1st Tranche: 6 months after write-off
    - 2nd Tranche: 6-12 months after write-off
- MFIs will develop their own internal adjustment policy to deal with the crisis situation. This may include loan rescheduling, grace period for repayments, reduction in interest rates charged on loans.

Duration: Q3 2006 – Q2 2009

Budget: USD 3 million for loan loss recovery matching grant and USD 1.2 million for operating cost sharing. In principle all MFIs would qualify as the objective of the loan loss recovery program is to preserve the microfinance sector as a whole [32].

[32] The monthly operational costs (excluding loan loss provisioning) of the microfinance sector as a whole are an estimated USD 300,000. A fifty percent coverage of these costs for a period of up to 8 months would amount to USD 1.2 million. The estimated funding amount required for the loan loss recovery matching grant is based on the sector's historical estimated aggregate loan loss of USD 5 million resulting the second Intifada. If we assume an 60 percent loan loss recovery, USD 3 million would be required for the matching grant.

4.4.2 Second Tier: Social Safety Loan (SSL)

Target Group:
- MFIs' existing clients
- Minimum credit history of **<u>1 year</u>** with MFI
- Maximum loan received less than **<u>US$1,000</u>** throughout credit history
- Maximum household income **<u>US$600</u>**

Purpose: With the estimated depletion of assets, the cessation of economic activity and continued limited mobility throughout the crisis period, the SSL would serve as safety net and would provide liquidity for the most vulnerable of the poor clients served by the MFIs. This, in turn, will strengthen the trust bases between the MFIs and their clients, and would minimize the psycho-social factors that may lead this target group to turn to less secular modes of financing. Most importantly, it would help the MFIs maintain their asset bases in the long run.

Methodology:
- Loan range: US$600-1000 (optional)
- Repayment grace period: 3 months (or longer, depending on duration of emergency)
- Interest Rate charges: 0%
- Loan maturity: 18 months
- 3-4 balloon payments – depending on loan amount, paid quarterly
- Parallel loans
- USAID will match 25% of all loans recovered by MFIs
- Clients are pre-approved for mainstream MFI loan products post recovery period

Assumptions:
- Estimated 10,000 clients to be served (60,000 family members)
- Eligibility of clients will also be contingent upon repayment history (less than 3% PAR › 30 days)

Duration: Q4 2006 – Q1 2008

Budget: US$10m + US$2.5m matching post recovery

4.4.3 Third Tier: Social Safety Credit Card

Target Group: MFIs' existing clients with a monthly household income < USD 600

Purpose: Subsistence; Secure basic needs (food; education; health; shelter; telecom/utilities)

Methodology:
- Credit card issued to clients for a fee (ex. US$20)
- Client gets credit line up to US$500
- Credit card may be used to withdraw from ATM machines or directly at *Points of Sale* (grocery stores; pharmacies; healthcare centers, etc…)
- Maximum withdrawal limit of US$50 per week
- Clients may pay into the account to maintain the credit line limit (the US$500 limit) at any time
- Principal amount due in instalments and payable on a quarterly

basis; 6 months grace period
- 0% interest up to 12 months; 8-12% annual interest charged on credit amount thereafter (deducted upfront upon renewal)

Assumptions:
- Credit limit may be renewable upon payment or if credit line is replenished by client
- Commercial banks need to be involved in servicing these accounts (account settlements)[33]
- MFIs disburse the credit cards directly to their clients
- MFIs retain the cash contribution collected upfront from client upon receiving credit card.
- Only clients with impeccable repayment history are eligible to benefit from this service.
- MFIs receive USAID grant earmarked for this activity
- MFIs settle amount for prepaid credit cards directly with the commercial banks.
- Example: Issuing bank (master card/visa, etc..) issues 50 debit cards for the value of US$500 each; the MFI pays the bank US$25,000 + 1% service charge. Repayments may be made directly with the partner banks.
- The card is a credit card from the point of view of the clients but because the card is fully funded it is a debit card from the point of view of the bank.

Duration: 12 months; subject to renewal

Budget: USD 5 million

Note of Caution

The SSL and SSDC must be carefully marketed by MFIs to ensure that such a micro-grant-like program does not (at worst) compete with or undermine the mainstream, best practice microfinance products, and (at best) is carefully coordinated with microfinance to provide an eventual way out of grant dependence.

Both the duration and the purpose of these designed products MUST be carefully and clearly defined to all stakeholders.

Reference Literature

Relevant literature and examples are available on the USAID funded Microlinks website: www.microlinks.org. Two papers written under the Accelerated Microenterprises Advancement Project (AMAP) are of particular relevance: “Microfinance Research in Conflict Environments: State of the Art and the Road Forward” (microNotes Issue number 2[34]), and “Microfinance Amid Conflict: Taking Stock of Available Literature” (microReport number 1[35]).

[33]Cairo Amman Bank would be interested to get involved as issuing bank. The cards will be issued in bulk for a fee of approximately US$10/card. Cards may be issued with preset parameters by buying a "BIN" number from issuing credit card company (Visa/Mastercard). Fee for buying "BIN" service is about US$15k. "BIN" parameters include repayment structure, credit/cash withdrawal limitations, customized logo, etc…

[34] http://www.microlinks.org/ev_en.php?ID=7121_201&ID2=DO_TOPIC

[35] http://www.microlinks.org/ev_en.php?ID=7127_201&ID2=DO_TOPIC

5. New Activity for Normal Case Scenario

5.1 Introduction

As the vulnerable target groups move beyond the conflict and begin to rebuild their lives, they affirm that being held accountable for a loan and empowered to invest represent a powerful return to normality. Many victims of man-made disasters feel that the most important thing is to "live in peace". Where and when this sentiment exists, microfinance can be and is an effective vehicle for improving clients' economic well-being[36].

Still, fundamental differences exist between the client market in a post-conflict situation and that in a normal developing context. First, more people in the post-conflict society are poor — a man-made disaster, such as a major conflict, makes the poor even poorer and drops most of the middle class down. Second, more people turn to self-employment and to the informal sector — some for the first time and some only until the formal sector is rebuilt.

Microfinance in a post-conflict context can be a multi-use tool. First, it can restart and boost local economic development by providing access to financial services. Second, it can be a component of the immediate post-conflict rehabilitation assistance.

5.2 Demand for Microfinance

Several sources estimate that there are 150,000 to 200,000 micro enterprises (up to 70,000 formal and 110,000 informal). The number of informal micro enterprises appears to have more than doubled since the start of the Intifada[37]. This should come as no surprise as many day-labourers working in Israel or in Israeli settlements lost their job and set up a business to generate income for the household. While several studies assume that all businesses need loans and should get loans, the assessment team strongly argues against this. First of all, not all businesses want loans: the Massar 2003 study shows the following reasons for not asking for a loan:

- No need (25.6 percent)
- Afraid of default (26.7 percent)
- Religious reasons (33.2 percent – 24 percent West Bank and 45 percent Gaza)

Second, not all businesses wanting a loan are eligible for a loan as they may not have the capacity to repay. With an increasing number of informal businesses, more businesses compete for the same customer (who gets poorer). Under this reasoning, less and less businesses become *eligible* for a loan, and in effect, the market may become smaller.

The Massar 2003 study shows that about 25 percent of micro businesses would want a loan[38]. If we assume that the number of informal businesses can only have grown since

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[36]Karen Doyle, *Microfinance in the Wake of Conflict Challenges and Opportunities*, Microenterprise Best Practices, July 1998.

[37] Massar 2001 versus Massar 2003

[38] It is interesting to note that the Massar 2003 study showed that approximately 3,300 micro businesses had loans in 2002, with about 27,500 wanting a loan. If we assume that half of those wanting loans would be eligible (an optimistic assumption), there were 13,750 businesses wanting loans and being eligible for loans while only 3,300 had loans. The MFI sector together at that time had about 12,000 active clients. The gap between the number of clients served by the sector at that time, and the actual number of businesses having

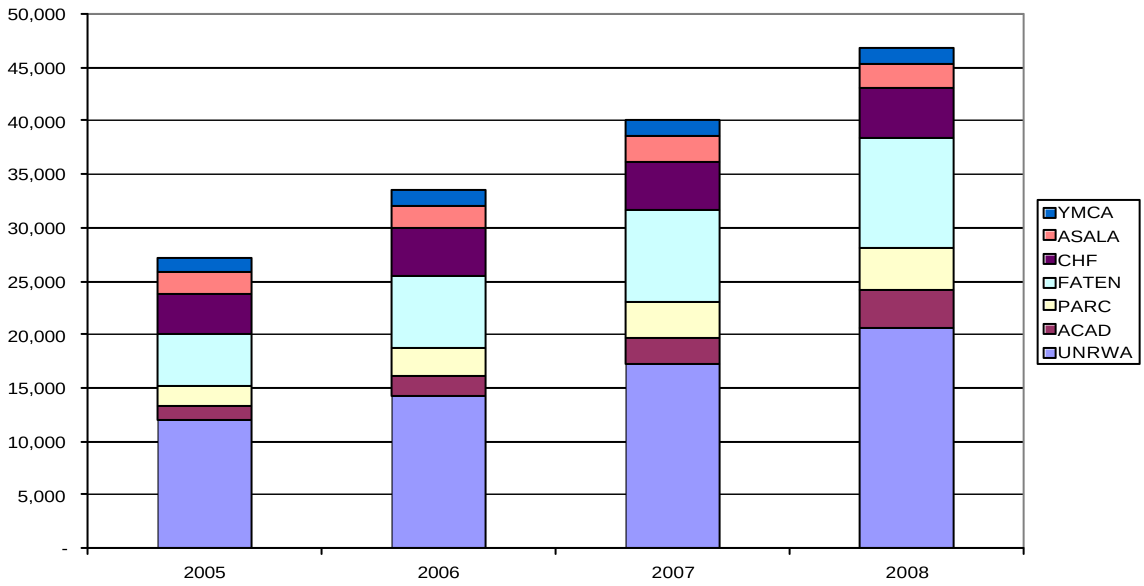
2003 (given the lack of job opportunities), a reasonable demand estimate would be 25 percent of the 200,000 estimate (50,000 potential clients). Demand would be higher by at least 25 percent if more Islamic finance products would be offered.

The above estimates show that demand in the West Bank and Gaza is limited. It must be noted though that the studies mentioned above only researched demand for *credit for enterprise purposes*. Other types of credit are needed too (housing, consumer, leasing) as well as other financial services such as savings and deposit services as well as remittances which could be quite a sizeable market during and after the crisis. No demand estimates are available on these type of services. There are an estimated 200,000 poor households but reliable data are lacking on how many of these households benefit from savings and deposit services.

5.3 MFI Projections

The MFIs were asked about their projections under the 'Normal' scenario. The scenario used was the World Bank's scenario "No Abrupt Change"[39]. The situation would be continue to be as it has been over the last few years (with the exception of the situation over the last period after the election of the new Government). This scenario assumes a return to 2005 practices: resumption of transfer of revenue transfer, continuation of border trade management practices, and a gradual reduction of Palestinian workers in Israel (or Israeli settlements) from 32,800 in 2006 to 7,400 in 2008. Under this scenario, poverty will have increased to 51 percent in 2008 and unemployment to 34 percent. GDI per capita is expected to decrease from USD1,657 year end 2005 (estimate) to USD 1,433 in 2008. Under this scenario, the MFIs together expected to reach over 45,000 active clients year end 2008 as is shown below.

Graph 11: Projections Number of Active Clients under Normal Case Scenario



loans according to Massar, may be an indication of a targeting issue, raising the question whether MFIs target the right people with the right products.

[39] Economic Update and Potential Outlook, March 15, 2006

5.4 Challenges for the Microfinance Sector

In order however for the sector to meet its year end 2008 targets, it has to face and overcome the challenges as described in Chapter 3: (i) legal Issues; (ii) governance issues – the need for legislation; (iii) grant dependency; (iv) issues concerning client responsiveness and market fit; (v) over-emphasis on achieving operational sustainability; and (vi) a lack of bank engagement and bank-MFI linkages. These issues are common for a microfinance sector operating in the consolidation phase of the sector and preparing to enter the integration phase. The new activity design presented in section 5.5 will address the issues mentioned above.

Box 8: Microfinance Industry Development phases

While each country has its own unique characteristics, by and large microfinance sectors develop through distinct phases, namely start-up, expansion, consolidation and integration.

In the Start-Up Phase, semi-formal microfinance activities are introduced as experimental pilot projects. In this phase initial products are developed and tested in the market. The emphasis is to build a human resource base capable of delivering credit products that ensure good repayment. Awareness is built that micro and small business entrepreneurs can be creditworthy. Some pilot projects fail often due to low repayment while others have gradually discovered techniques that are applicable to the local context. In environments where microfinance is, initially, legally not allowed successful pilots often convince local authorities to condone the activities due to the perceived benefits for the livelihoods of poor households, employment generation and economic development.

In the Expansion Phase, successful MFI's mostly concentrate on expanding the scale of their existing operations. The success of their business model allows them to expand their activities and to capture a large share of the potential market. Their success leads to replication by other microfinance operators. The emphasis in this stage is on expansion of existing activities and on resource mobilization to finance the expansion. The expansion leads to economies of scale and higher efficiencies with the result that successful MFIs are increasingly able to finance their operations through income generated from interest and fees. At this stage MFIs are still subsidized by grants and soft loans to finance the expansion. The increased scale of operations requires further institutional strengthening particularly in the areas of management systems and procedures. At the end of this phase MFIs have captured a large part of the market with their existing products.

In the Consolidation Phase successful MFIs start to focus on their overall sustainability. The emphasis in the consolidation stage is on strengthening the institution as a whole, and organizational formalization. Management oversight, organizational policies, procedures and systems are managed in a more formal manner. The microfinance sector also formalizes by gradually establishing generally accepted industry norms. Subsidies of donors of the sector are diminishing in order to avoid continuous subsidization of institutional development. As a consequence, MFIs are required to further increase their productivity, to further expand in scale and scope and to adjust their pricing policies to ensure profitability and growth. At this stage, the penetration rate of the existing target markets has become high. Increased competition requires that products are made more flexible and oriented to customer demand. New products such as insurance, consumer lending or house-improvement finance are introduced. In addition, some MFIs start venturing in markets for microfinance that have been neglected. One important market is the small business sector that has no or limited access to the formal banking sector[40].

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[40] To support access to microfinance for the small businesses often translates into job creation for poor people that prefer to be wage employed rather than to be self-employed

In order for the sector to enter into the integration phase it is important that by the end of the consolidation phase a special regulatory framework is in place that is conducive to the development of the microfinance sector and allows for effective prudential regulation by the Central Bank or another relevant agency. The development of such regulations normally takes place before the end of this phase when a critical mass of MFIs is ready to integrate into the formal financial system.

In the Integration Phase leading MFIs have become an integral part of the formal financial sector, regulated by the Central Bank or other relevant agency and offering a range of demand oriented products for the lower segments in the market. This integration is required for the sector to be able to further finance their growth by attracting capital from commercial sources (savings deposits, loans and equity). Instead of drawing on government, donor funds and subsidies, these MFIs contribute to public funds by paying taxes common to the financial sector. The integration phase is characterized by transformation of MFIs into regulated financial institutions, the disappearance of subsidies for the microfinance sector; the up-scaling of microfinance institutions and the downscaling of commercial banks that, due to an unsubsidized microfinance sector, are now able to operate on a level playing field[41]. Licensed MFIs continue efforts to downscale their services, especially with respect to offering savings services to the very poor.

Formal financial institutions will become increasingly engaged in microfinance by establishing subsidiaries, separate banking units or other modalities to provide financial services to poor and low-income people. Unregulated microfinance operators are moving towards formalization and commercialization in order to be able to finance their growth by attracting capital from the private capital markets and deposit taking from the public.

There is a general consensus among key players in the field that the trend towards integrating microfinance as part of the formal financial system will continue and eventually prove dominant. It is expected that the number of commercial and regulated financial institutions that provide microfinance services will increase[42].

5.5 New Activity Design

5.5.1 Guarantee Facility for Bank Loans to MFIs

The MFIs together expect to have an outstanding portfolio of approximately USD 64 million y/e 2008 under the 'Normal Intifada' case scenario. They would be serving together over 45,000 active clients.

Table 5: Estimated Loan Portfolio Outstanding – 3 year projections

	2005	2006	2007	2008
UNRWA	7,543,731	9,360,000	11,700,000	14,620,000
ACAD	2,933,595	3,500,000	4,200,000	5,000,000
PARC	1,949,555	3,569,956	4,595,241	5,419,048
FATEN	8,944,000	9,701,406	11,959,705	15,305,367
CHF	8,936,854	10,814,572	14,934,538	17,226,421
ASALA	1,589,398	1,558,855	1,826,467	1,984,366
YMCA	3,264,000	3,857,525	4,525,450	4,545,600
	35,161,133	**42,362,314**	**53,741,401**	**64,100,802**

[41] See figure 2
[42] UNCDF Microfinance Sector Development Approach, 2004

Allowing for excess liquidity in some MFIs, an estimated additional USD 24 million in additional loan funds would be needed for the MFIs to meet their year end 2008 targets. Ideally, MFIs would tap on the excess liquidity in the Palestinian banking sector, and borrow from banks for onlending to the micro entrepreneurs. In order to create incentives for a bank to make a loan to a MFI, USAID could implement a (partial) guarantee scheme. This would be a novel intervention in the Palestinian microfinance sector and USAID could set a new best practice standard. Such intervention in the area of guarantees for bank loans to MFIs, would achieve the following objectives:

- Create commercial linkages between microfinance sector and the banking sector;
- 'Free up' scare donor grant money
- Instil a commercial orientation and discipline in MFIs
- Enhance transparency and accountability of MFIs

USAID could explore two options to implement such a guarantee facility: (i) the Agency's 'own' DCA program; and (ii) creating a window in the European Palestinian Credit Guarantee Facility (EP-CGF).

The Guidelines for the DCA state that guarantee instruments can only be utilized when the partner is a non-sovereign entity[43]. This would be the case with banks in the West Bank and Gaza. There is already one example of the use of DCA in the West Bank and Gaza, the agreement with the Bank of Jordan for loan guarantees on loans to small businesses. This program was recently suspended because of the political situation but a precedent has been set.

The DCA guarantees 'only' up to 50 percent of the loan amount. Given the economic and political environment – even under more calm circumstances – this may not be enough of an incentive (yet) to encourage banks to lend to MFIs. The team therefore recommends USAID to obtain a waiver from DCA to allow for higher than 50 percent loan guarantees.

Therefore USAID could also explore the option to cooperate with the EUR 30 million European Palestinian Credit Guarantee Fund, an initiative set up by the KfW and co-financed by EIB and EU. The facility has concluded agreements with 5 banks for onlending to small businesses and guarantees up to 60 percent of the loan amount[44].

The assessment team discussed the option to create within the EP-CGF a special window for bank loans to MFIs. The management of the EP-CGF is in principle favourable to such a concept but also indicated that it prefers to get is individual small business loan guarantee program fully operational before it would consider guaranteeing bank loans to MFIs.

If a special window would be set up in the EP-CGF, USAID is recommended to implement the guarantees on a declining basis, allowing banks to get 'used' to lending to MFIs. The guarantee could be up to 70 percent in the first year, 60 percent in the second year and for instance 50 percent in the third year.

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[43] www.usaid.gov/our_work/economic_growth_and_trade/development_credit/guiding_principles.htm

[44] These banks are: Cairo Amman Bank, Bank of Jordan, Jordan National Bank, Bank of Palestine and the Arab Islamic Bank.

A Note of Caution

An intervention guaranteeing bank loans to MFIs may be premature as donor grant funds appear to be abundantly available in the foreseeable future. The largest microfinance project in the pipeline is the UNDP-IDB project. The UNDP recently signed an USD 30 million project document with the Islamic Development Bank, to empower deprived families. USD 15 million of this project is allocated for funds for onlending for the MFI sector.

More-over, if the ‘Normal Intifada’ scenario, would occur after the ‘Emergency case’ scenario, USAID would have already availed up to USD 15 million in loan funds for onlending for the proposed social safety net loans. MFIs would use the repayments of these loans for regular operations.

Hence, at least USD 30 million is expected to be ‘pumped’ into the microfinance sector, meeting the funding needs of the MFIs and – in effect – hindering normal microfinance sector development and graduation towards a more commercial orientation.

However it is likely that the terms and conditions of the IDB project may not be acceptable to some MFIs for the following reasons: (i) IDB may require the MFIs to use Islamic finance principles – which are in effect more expensive to the borrower and logistically quite cumbersome; or (ii) IDB may require the MFIs to engage in subsidized lending.

The table below summarizes some of the minimum and maximum required funding for the guarantee facility under four different scenarios: (i) emergency situation occurs (and USAID makes up to USD 15 million in loan funds available) and IDB offer is attractive to MFIs (and makes USD 15 million in loan funds available; (ii) emergency situation does occur and IDB offer is not attractive to MFIs (resulting in a funding gap of USD 9 million); (iii) emergency situation does not occur and IDB offer is attractive (resulting also in a funding gap of USD 9 million); and (iv) emergency situation does not occur and IDB offer is not attractive (resulting in a funding gap of USD 12 million).

Table 6: Required Funds for Guarantee Facility under Different Options

	Funding Gap	Minimum amount needed (if 50 percent guarantee)	Maximum amount needed (if 70 percent guarantee)
Emergency scenario does occur and IDB offer is attractive to MFIs	0	0	0
Emergency scenario does occur and IDB offer is not attractive to MFIs	9 million	4.5 million	6.3 million
Emergency scenario does not occur and IDB offer is attractive to MFIs	9 million	4.5 million	6.3 million
Emergency scenario does not occur and IDB offer is not attractive to MFIs	24 million	12 million	16.8 million

5.5.2 The Capacity Building Innovation Facility

A variety of capacity building needs were identified during the sector assessment. Some of these are common to MFIs in the consolidation phase of sector development, while other needs address issues that should be resolved in order for the MFIs to enter the integration phase. The needs identified during the mission can be categorized as follows:

Table 7. Categories and Examples of Capacity Building Needs

Category	Description – examples
Governance	Issues pertaining the 'ownership' and management of a MFI ▪ Delineation of tasks and responsibilities of Board versus Management including the (re)drafting of a MFIs Statutes/Charter to ensure appropriate oversight ▪ Training of Board Members and General Assembly Members ▪ Development of Board Member Training Manuals/Kits ▪ Selection of Board Members ▪ Legal and Institutional Spin off (CHF)
Product Development	Issues pertaining the design of loan products and terms and conditions that meet the needs of the client group ▪ Client needs assessment ▪ Business (cash flow) cycle analysis of economic sub-sectors ▪ Product development based on client needs; grace, maturity, repayment schedule, interest and fees, guarantees ▪ Product costing ▪ Development (or re-introduction) of alternatives to salary guarantees ▪ (Sub-) Sector Lending
Cooperatives	▪ Strengthening cooperative movement ▪ Expansion of the cooperative movement
Strategic planning	▪ Strategic planning skills ▪ Strategic planning facilitation
Legal issues	▪ Legal status of microfinance organisations ▪ Fiscal status of microfinance organisations ▪ Not for profit company legal form (re-instatement) or for-profit company tax exemption
Pilots and experimentation	▪ Demand study on savings as a service ▪ If there is a need for savings, design a program to increase the access of the poor for savings services ▪ Demand study for insurance as a service ▪ If there is a need for insurance, design a program to increase the access of the poor to such services

The capacity building needs are varied and MFI specific. General training courses or workshops – which are being provided – will not be sufficient. More tailor made assistance is needed. However MFIs need to learn to integrate some capacity building activities that they currently only do if grant funding is available in their day-to-day operations. For instance, client needs assessment, product development and costing should become routine operations and – over time - be financed out of the MFIs operational budget. The proposed Capacity Building and Innovation Facility described below – would expect MFIs to co-finance their own capacity building needs. This will demonstrate and enhance their commitment to the capacity building.

The Capacity Building and Innovation Facility will co-finance the MFIs capacity building needs. Support may be in the form of financial or technical assistance. The Facility will also fund pilot projects and experimentation especially in the area of new product development.

- MFI will specify the need; submit a proposal and budget (not more than 4 pages)
- If the proposal is for an activity that over time should become part of MFIs operations, the MFI should demonstrate in the proposal how it would do so over what time frame. Up to 50 percent can be co-financed.
- Certain unique capacity building activities such as certain legal activities or a spin-off could be co-financed up to 75%.
- Groups of MFIs – for instance those facing the NGO transformation into (not for profit) company – could submit a joint proposal.

When evaluating and approving proposals, three principal criteria will be applied — institutional capacity, the quality of the innovation proposed, and cost sharing—providing a detailed format to guide proposal preparation. Given the governance issues faced by most MFIs, training of Board members and clear delineation of tasks and responsibilities between Board members and management, could be a required activity that all MFIs will have to undertake in order to be eligible for co-financing of any of the other possible activities.

The Facility will be promoted through a project web-site and through bulletins and invitation letters. Proposals will be received, reviewed, and approved for funding on a rolling basis by a standing grants committee comprised.

The successes and lessons learned from the funded activities will be documented and disseminated. While such dissemination will be sensitive to confidentiality issues and the competitive nature of the MFIs, dissemination is critical to ensure ongoing innovation and expansion beyond the life time of the facility.

The estimated budget for the Facility is USD 3 million. This includes USD 500,000 to assist CHF with the envisaged spin off and USD 500,000 for legal and regulatory work for the sector as a whole.

Chapter 6. Evaluation of FATEN

6.1 Summary

Palestine for Credit and Development (FATEN) was registered as a non-profit limited liability company with the Ministry of Justice in 1998. It began operations officially in 1999 after the spin-off from Save the Children to take over the group guaranteed lending and savings program that was initiated in 1995. The staff has been entirely local since inception, even under Save the Children. FATEN provides working capital loans for groups and individuals, as well as consumer and home improvement loans for a total of approximately 5,000 active clients, mostly women, with an outstanding portfolio of US$10.1m by end of April 2006. Since its inception FATEN has disbursed over 71,000 loans with a value of USD 42 million. Ninety nine percent of clients are women. As of today FATEN has 67 staff and 15 branches. USAID has been the major financier of FATEN and has provided over USD 4.2 million in grants to FATEN

Table 8: Market Positioning [45]

Environment	Unregulated
Maturity	Mature: 7 years
Scale	Large: Portfolio of US$9.5m
Target Market	Broad (>100% GDP per capita)

Table 9: Key Performance Indicators

	2000	2001	2002	2003	2004	2005
# of Employees	82	84	79	77	57	66
Total Assets (US$)	3,570,000	5,134,000	5,460,000	5,551,000	6,414,000	11,683,000
Outstanding Portfolio (US$)	1,187,000	1,454,000	549,000	1,261,000	2,383,000	8,944,000
Active Borrowers	4,352	4,498	1,728	2,293	3,319	4,777
PAR (>30 days)	21.58%	7.19%	22.45%	3.19%	2.03%	1.6%
Risk Coverage Ratio [46]	--	110%	99%	180%	175%	190%
Write-off Ratio	0%	11%	24%	0%	0%	0%
Portfolio Growth	0.07%	20%	-61%	130%	89%	275%
Asset Growth	47%	44%	6%	2%	16%	82%
Staff Productivity	66	58	35	30	58	72
Portfolio Yield [47]	57%	54%	36%	24%	26%	18%
Operating Expense Ratio [48]	76%	68%	90%	97%	47%	17%
OSS	69%	75%	41%	47%	66%	96%
FSS	59%	63%	38%	44%	57%	73%

[45] Categories as defined by the MicroBanking Bulletin: Scale (outstanding portfolio US$): Large (> 8 million); Medium (2-8 million); Small (<2 million); Target Clientele (Average Outstanding loan/GDP per capita): Low-end: < 20% or average outstanding loan = US$150; Broad: 20% - 149%; High-end: 150% - 249%; Small Business: 250%; Maturity (years of operation): New: 1-3 years; Young: 4-7 years; Mature: over 7 years.

[46] Risk coverage ratio: loan loss reserves/portfolio at risk (>30 days)

[47] Portfolio Revenue/Average Gross Outstanding Portfolio

[48] Operating Expense/Average Gross Outstanding Portfolio

The microfinance environment in Palestine is characterized by both market rate and credit providers that are donor-fatigued and lend at low rates because of either a) over-liquidity, or b) developmental mindset that the poor are not bankable - with the latter having a high percentage of the aggregate outstanding loan portfolio[49]. USAID has played a key role in supporting the microfinance sector in Palestine, notably two out of three key market-oriented MFIs (FATEN, CHF).

- **Key Strengths:** FATEN is the strongest of all MFIs operating in Palestine to date. FATEN's key strengths include a very positive reputation in the community for serving women, a well-established experience in group lending methodology targeting the poorer segment of women entrepreneurs, a comprehensive individual credit methodology, an effective MIS, and very strong and systemized internal control procedures.

- **Areas for Improvement:** FATEN has opportunities to improve by formalizing the Board functions through internal rules and committees, developing a long-term business plan[50], ensuring access to commercial funds to eliminate total dependence on donor grants, increasing staff productivity, as well as eliminating subsidized, riskier product lines (consumer loans and home improvement loans).

- **Principal Risks (Emergency Scenario):** The principal risks include downward pressure on profitability with declining portfolio yield, a slowdown of lending activity, a soaring default rate, and pressure on management to deal with yet another unfolding crisis due to the suspension of salary payments, tax transfers and donor funding: while the portfolio at risk over 30 days (PAR > 30 days) stood at 4 percent at the end of April 2006, the PAR > 1 day stood at 24 percent. This is expected to spill over into a PAR > 30 days as the salary crisis continues.

[49] Mainly due to housing loans provided by CHF and FATEN which constitute 30% of the aggregate outstanding portfolio.
[50] The Board and management held a strategic meeting/retreat in Amman/Jordan in May 2006 as a precursor to developing a 3 year business plan.

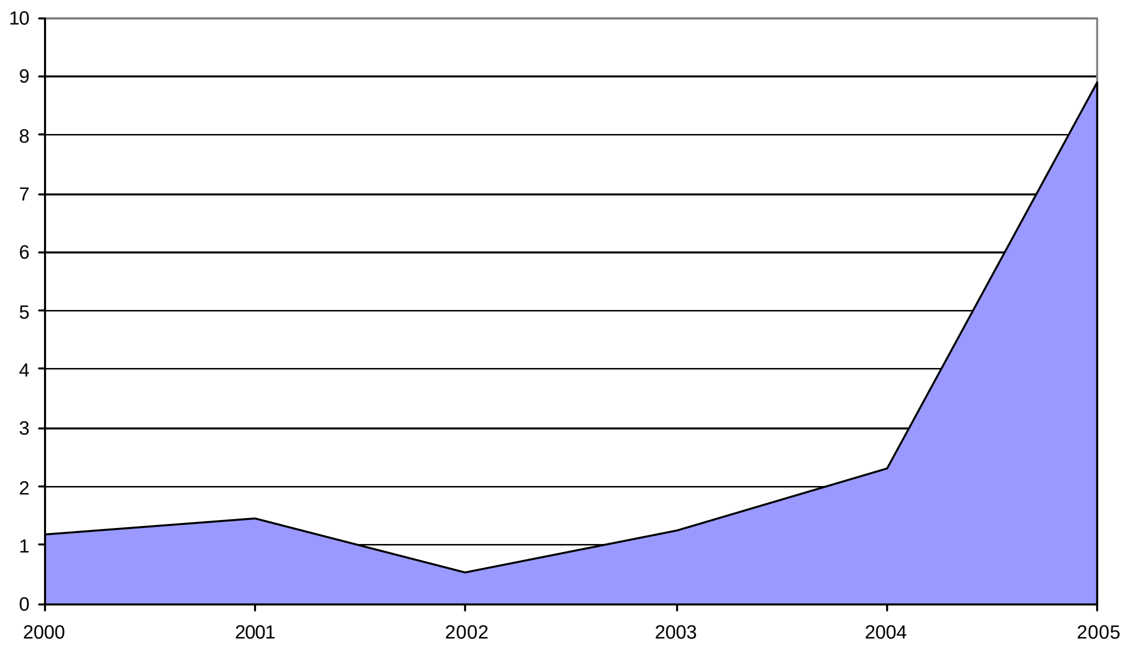
6.2 Institutional Presentation: FATEN in a Snapshot

Mission
FATEN's mission is to strengthen the economic base of Palestinian micro entrepreneurs, particularly women, through the provision of high quality financial services suited to their needs.

FATEN's strategic goals are:
- To provide Palestinian micro entrepreneurs with sustained access to financial services;
- To offer diverse credit and financial services;
- To maximize cost-efficiency while providing strong client-responsive services;
- To become a financially sustainable institution.

Loan products
FATEN offers nine loan products: Loans range from US$70 – US$15,000 with maturities reaching a maximum of 48 months. FATEN only offers a grace period for its housing loans. Interest charged on loans varies from 0.5% - 3.3% flat per month. Clients are also required to pay additional loan application fees. Annual effective interest rate ranges from 15% (housing and family loans) to 160% (fast/seasonal loans). All loan disbursement and repayments are done through four partner banks: Jordan National Bank, Arab Bank, Cairo Amman Bank and Bank of Palestine.

Graph 12: Evolution of Loan Portfolio Outstanding (in USD million).



Year end 2005, FATEN had a loan portfolio outstanding of USD 8.9 million. The rapid increase in loan portfolio outstanding was mainly due to FATEN receiving a very large grant from USAID (USD 4.9 million) that had to be disbursed within one year.

Legal form and supervision
FATEN is an independent, limited liability, non-profit company registered with the Ministry of Justice in 1998 after the spin-off from Save the Children. With the sole

function of providing microfinance services to poor Palestinians, FATEN is not regulated or supervised by any banking authority.

Ownership
As per the statutes of incorporation, FATEN is a non-profit limited liability company that is owned by16 founding shareholders (15 individuals + 1 representative of Save the Children, U.S.A). The company's capital is US$10,000. Technically, Save the Children (SC) has a 26% stake in the company with the remaining shares equally distributed among the founding shareholders. In reality, SC has paid in 64% of the paid-in capital as other members have only paid in a minimal amount towards that.

In the case of liquidation, all FATEN assets shall be transferred to an institution with similar vision, mission and objectives. None of the assets shall be distributed among shareholders who will only be eligible for receiving the value of their paid in shares.

The General Assembly (which is comprised of the founding members) appoints the Board of Directors to govern FATEN. There are currently 8 active Board members out of 9 (as per FATEN's bylaws).

Table 10: Board of Directors FATEN

BOARD of DIRECTORS	**Position**	**Since**	**Profession**
Naser Abdul Karim	Chairman	2004	Professor, Bir Zeit University
Nebras Bseiso	Vice-Chairman	1998	Palestinian Banking Corporation/Gaza
Na'ela Ayesh	Member	1998	Director of Women's Affairs Center, Gaza
Sameer Abuzunaid	Member	1998	Dean of Faculty of Commerce / Hebron University
Hiyam Qa'qour	Member	1998	Women's Center for Legal Aid / Lawyer
Mohammad Al-Saqqa	Member	1998	Lawyer – Khan Younis
Abdel Kareem Ashour	Member	1998	Director of PARC/Gaza
Samir Abdallah	Member	1998	Director of the Palestinian Economic Policy Research Institute (MASS)

Networks and alliances
FATEN has been a member of the Palestine Microfinance Network and of the Microfinance Network of the Arab Countries (SANABEL) since 2002.

Management Team and Structure
FATEN is headquartered in Ramallah with a network of 11 branches (served by 3 regional offices in Gaza, South - Bethlehem and Hebron - and North – Nablus, Tulkarem and Jenin) covering more than 300 locations in the West Bank and Gaza.

FATEN is managed by a director with extensive experience in banking who joined in March 2004. The managing Director is assisted by one of the most experienced and competent management team in the field of microfinance in Palestine. The management style is participatory and the branch offices are largely operationally autonomous.

FATEN is in the process of strengthening its operations team by recruiting a key Operations Manager – a long-standing need for the institution – as well as a Research and

Development Manager to handle new product development and marketing to better meet clients' needs.

Human Resources	2002	2003	2004	2005
Number of Employees	79	77	57	66
% Loan Officers	43%	46%	53%	56%

Audits and Reporting

Talal Abu Ghazaleh & Co. has been appointed as external auditors as of financial year 2005 replacing Ernst & Young. The auditor performs annual checks on accounts. Issues raised in the Auditors' Letter to Management are considered immaterial.

Despite the fact that FATEN is also subject to regular external audits by Save the Children and USAID – its largest funders – this right has not been exercised by these funders to date. FATEN maintains its accounts in Jordanian dinar (JOD), but it uses U.S. dollar as its reporting currency.

6.3 Loan Portfolio, Loan Products and Clients

Although the key MFIs present in Palestine were historically expected to serve relatively different market segments based on their geography and target groups, these MFIs are adopting the same strategies in their client outreach and product development. Not only are most of the operating MFIs competing directly for a limited target group, they are also in direct competition with commercial banks that have recently seen the value of scaling down their operations.

Initially, FATEN's market presence was focused exclusively on low-income women clients within a group lending methodology, but over the past two years this has strategically shifted to include more registered businesses and even men. This shift has also compelled FATEN to offer products at subsidized interest rates (such as consumer and housing loans) in order to compete with commercial banks that offer consumer loans at lower rates with sufficient salary-guarantees. The reasons cited for this shift in focus is attributed to the following:

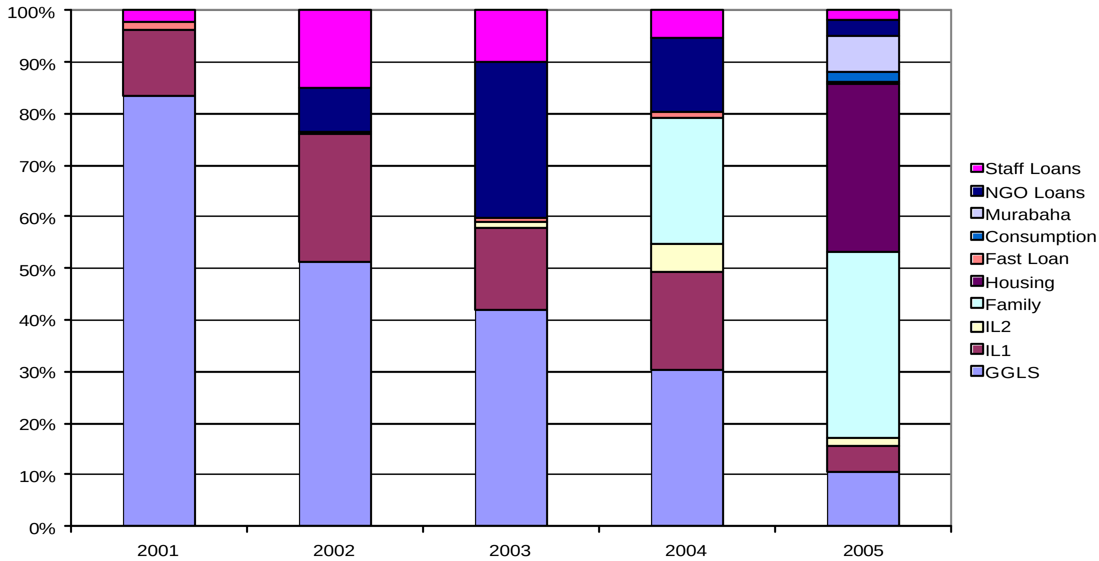
- Increased liquidity and donor pressure to spend, spend, spend in a limited timeframe ➔ high-end loans
- Fear of increasing default among non-guaranteed loans (as was the case following the second Intifada and the 2002 closures).
- Attraction and availability of an extensive market for salary-guaranteed loans;
- Limited market for low-end group loans particularly targeted to women.

Portfolio Diversification: Products and Services

FATEN offers 9 different loan products covering a wide range of needs, as summarized in Annex 5. FATEN plans to diversify its product line further by introducing computer loans and an adjusted group guaranteed loan structure. FATEN also plans to eliminate the compulsory savings component on it GGLS loans. The reason for this is two-fold: (i) FATEN has no legal right to mobilize savings as a non-profit limited liability company; and (ii) clients use the savings a repayment tool towards the end of the loan cycle.

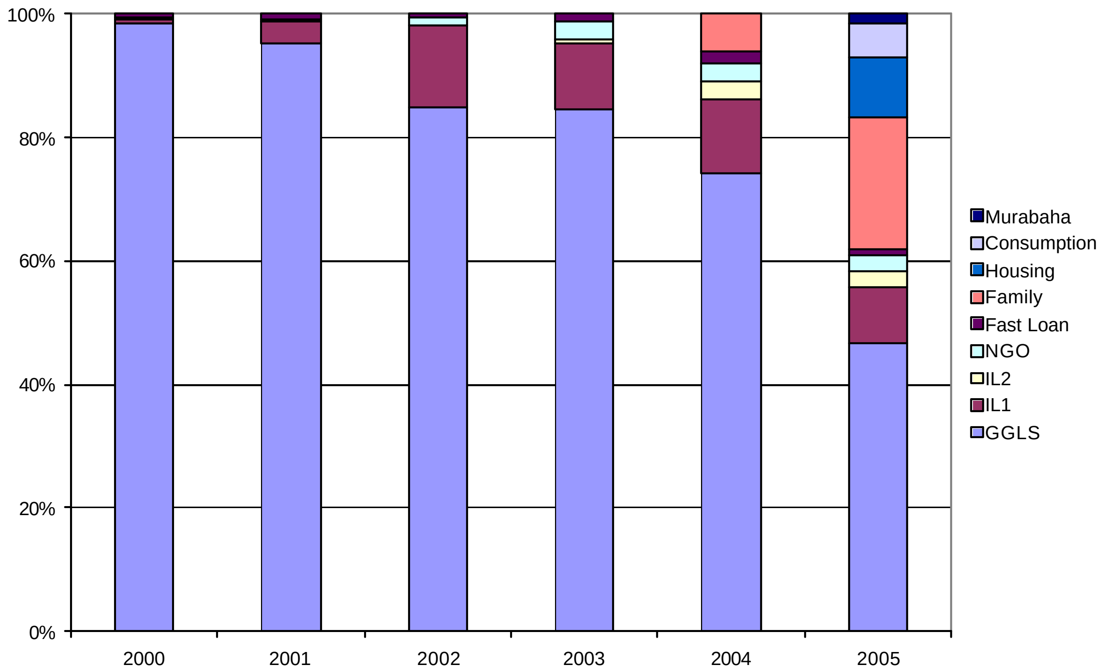
As discussed earlier, FATEN's portfolio jumped by more than 300% from 2004 to 2005 following a USAID grant injection of US$4.3m. With increasing liquidity, FATEN introduced the family, consumption and housing loans to serve a higher end of the market. As is shown below, year end 2001 the bulk of the loan volume constituted of group loans (GGLS) and very small individual micro-loans (Individual Loan I – IL1), year end 2005, the bulk (75 percent) of the loan portfolio outstanding comprised of larger loans to not so poor clients (housing loans and family loans).

Graph 13: Evolution of the Loan Portfolio Outstanding per Loan Product



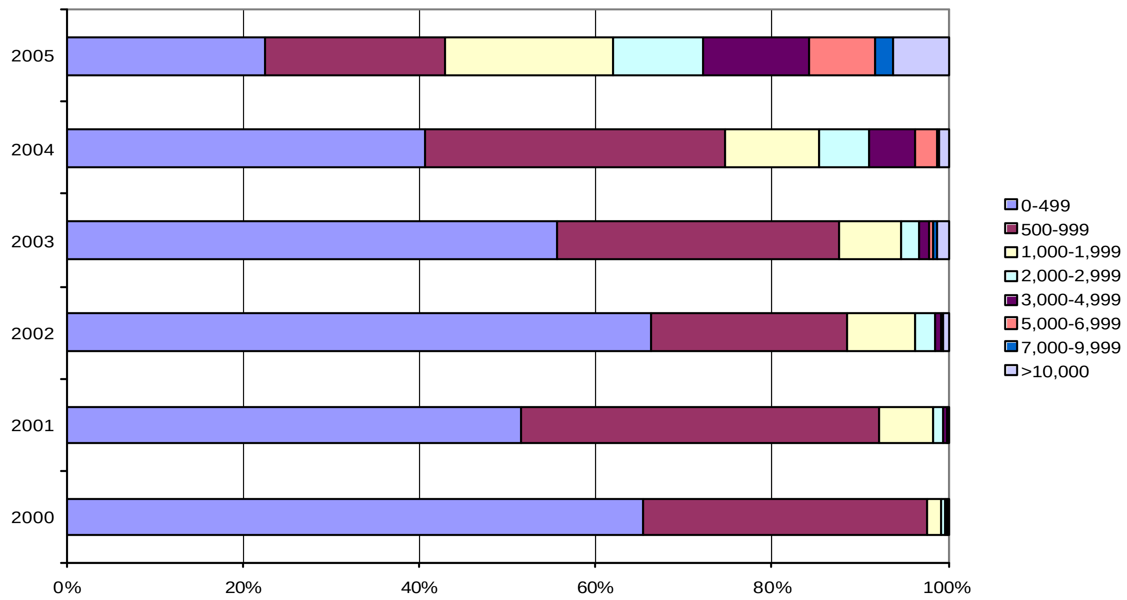
In terms of active clients, group borrowers and very small micro businesses taking group loans or individual micro-loans still constitute about 50 percent of active clients but the trend in serving this clientele appears to be downwards as is shown in below:

Graph 14: Evolution of Number of Active Clients per Loan Product



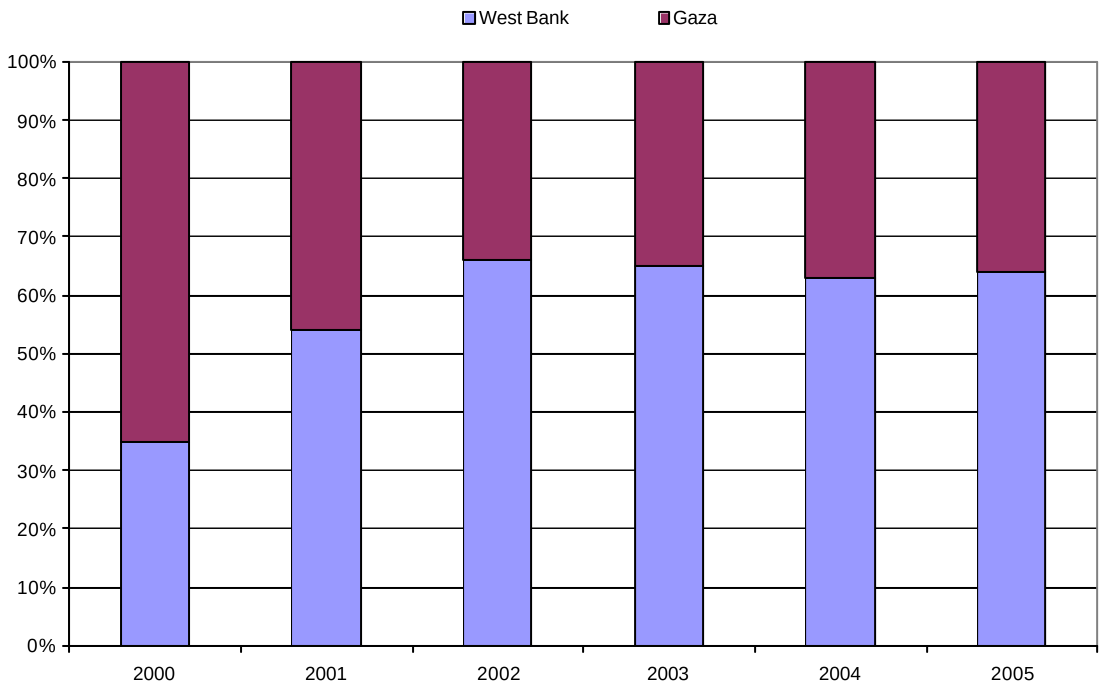
The bulk of the portfolio shifted to servicing loans larger than US$1,500, with more than 57% of the total loans falling under this category as is shown below. The annual percentage rate (APR) on these larger loans is however much lower than the APR on the group and micro-loans. In effect, the 'larger' loans to the not-so-poor people, are being partially subsidized by the income generated on the group and individual micro-loans. As we will see later, the overall yield on FATEN's portfolio decreased.

Graph 15: Evolution Number of Loans per Loan Size



Perhaps FATEN's shift to not so poor clients also explains the development that nowadays the majority of clients live in the West Bank, while in the past this was the other way round with the majority living in Gaza.

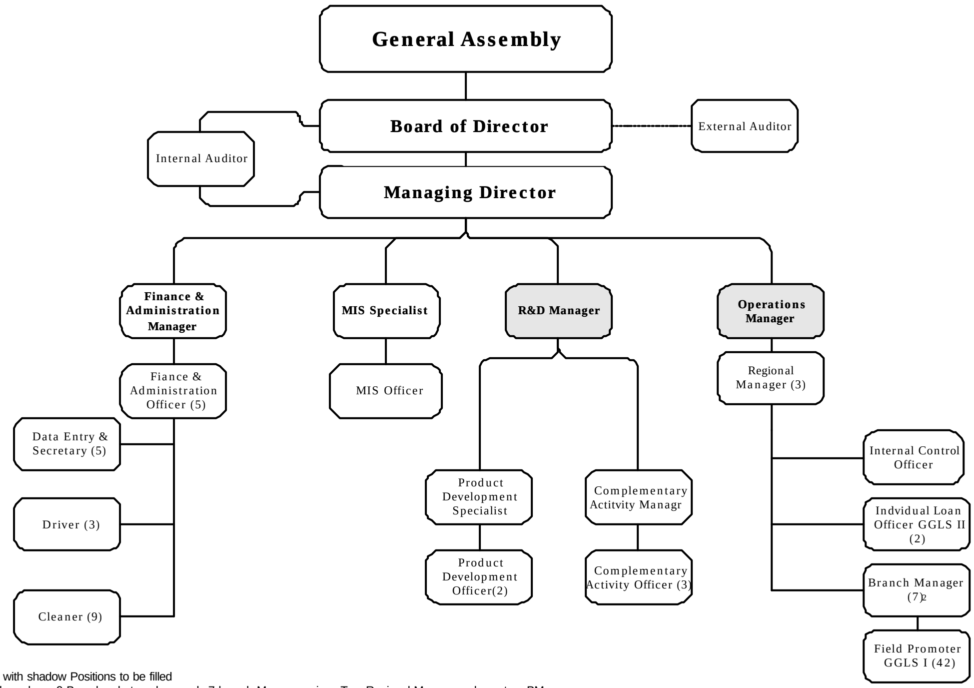
Graph 16: Evolution of Geographic Distribution of Clients



6.4 Governance and Decision Making

FATEN Organizational Chart

Annex # 1



(1) Boxes with shadow Positions to be filled
(2) Though we have 9 Branches but we have only 7 branch Managers since Two Regional Managers also act as BM

Decision-making Process

The current decision-making process is centralized within the management team but *very* actively supervised by the Board of Directors. The management team develops policies regarding areas such as operational strategy, new products, and policy amendments. The Board of Directors reviews these policies and plans and keeps decisions at check if they feel these do not serve the institutions mission. However, the presence of certain members on FATEN's board may pose conflict of interest in the decision-making process as these individuals also serve on the Boards of competing institutions. In certain areas, it may be more effective if the FATEN's Board minimized its involvement and delegated these decisions to management, especially at the operations level (product development, signing of minor agreements, etc…).

Save the Children, founder and largest shareholder of FATEN, is not represented on the Board but has been considerably involved in strategic alliances (especially with USAID) as well as technical capacity building. Given SC's experience in microfinance and its extensive network of microfinance institutions in the region, it would be highly valuable to have them represented on the FATEN's Board. The Board's composition could be further enhanced by having more diversity among the members (such as legal, private sector, banking backgrounds) as well as by expanding the General Assembly base. The current Board is comprised of 8 members, all of whom come from NGO and academic backgrounds. The Board members have been involved with FATEN since its inception.

Governance Issues

Additionally, to ensure the continuity and proper functioning of the Board, FATEN will need to formalize the governance aspects. Whereas FATEN uses the Articles of

Incorporation as the main reference for the Board's functions, it needs to develop an elaborate Board manual that clearly defines the roles and responsibilities of the Board and the relationship function with the management. The manual should also include such information as Board member terms, elections, and rotation, as well as the creation of functional committees.

Although the ownership of FATEN is technically clear, 26% of shares are owned by Save the Children and 74% owned by the founding shareholders, there are some legal ambiguities that should be noted. In case of dissolution, the shareholders will be responsible for the obligations of the entity in proportion to their paid-in capital, which they have not actually paid. Furthermore, Save the Children's involvement is not clear, but at a minimum it was designed to help ensure the preservation of the institution's mission. Again, FATEN should seek to widen it General Assembly base, pressure the members who have not paid into the capital to do so or leave, and to incorporate member rotation policy therein.

Management Information

The management team and Board have access to regular and complete quantitative and qualitative management information. All levels are informed of the strategic decisions taken by the management and the Board. Although joint staff meetings are not possible at the regional area-head office levels due to limitations in mobility (as a result of border closures and difficulty in or inability to receive entry permits among major areas within the West Bank and Gaza), the management team meets on a regular basis and is proactive in decision-making.

Planning

FATEN has operated without a Business Plan since 2002. The period between 2002 and 2004 proved critical for the institution as FATEN underwent a major change in management as the founding Director resigned from his post. At the same time, FATEN got hit hard in 2002 during Operation Defense Shield with a 60% drop in portfolio activity and a sharp increase in PAR to 22%. Still, the strength and resilience of the management team helped FATEN recover fairly quickly.

FATEN's Board and management team held a strategic planning retreat in April, 2006, which resulted in formulating a 3-year Strategic Plan. Despite the political and economic uncertainties that are characteristic of the Palestinian market, FATEN's strategic plan should serve as a good reference guide to the governing body as it delineates various scenarios and courses of action for each.

6.5 Management and Human resources

Given the limitations that the institution continues to face, FATEN has a strong human resource base. The management team and staff can be characterized as a good turnaround instrument for keeping the institution alive during two major crises in 2000 and 2002 (as well as a current unfolding major political and economic crisis). The management team is cohesive and decision-making is participatory with relative autonomy given to the regional managers. The team is strong operationally, but key improvements could be marked in areas of product development, market positioning, as well as funding and liquidity management.

Still, technically, FATEN could invest more in building the field staff technical capacity to handle project and market analysis more efficiently and effectively. FATEN offers an acceptable salary and benefits package, but it could better be adjusted to account for increasing cost of living. Additionally, the bonus criteria for loan officers can be better adjusted to push for higher staff productivity. Under the current policy, the star loan officer may only receive up to 50% of the monthly salary in bonus. The bonus is linked to three criteria: (i) increasing outstanding portfolio balance by at least 10% from previous period; (ii) increasing the number of active clients by at least 25% with concentration on GGLS loans; and (iii) no delinquency on issued loans.

While these criteria are relatively vague and expansive, they do not reflect on higher productivity among staff. FATEN needs to examine its lending strategy over the coming period and to build an incentive system that would contribute to reaching the institution's goals.

Table 11: Human Resource Overview FATEN

	y/e 2003	y/e 2004	y/e 2005	31/03/2006
# Total Staff	77	57	66	69
# Staff hired during period	11	8	16	5
# Staff who left during period	11	28	7	2
Turnover Rate (Staff who left/total)	14%	49%	11%	3%
# Loan officers	35	30	37	37
% Loan officers/total staff	46%	53%	56%	54%
# Admin staff	19	9	9	10
% admin staff/total staff	25%	16%	14%	15%
# frontline staff	7	6	7	8
Annual loan officer salary (US$)	3,600	4,200	4,800	4,800
Annual loan officer benefits (US$)	1,764	1,872	2,076	2,076
TOTAL annual LO salary & benefits (USD)	5,364	6,072	6,876	6,876

6.6 MIS Management Information System

FATEN has developed an in-house loan tracking system, "Al-FATEN". The system is flexible and user friendly with capacity to absorb several products and variables. It uses MS-SQL as database engine and MS-Access as frontline interface. The system in centralized in Ramallah and is connected with the 4 regional branches in Gaza, Bethlehem, Hebron and Nablus through leased lines.

The system generates all key portfolio reports at different branch levels. Report can easily be obtained for any period and track different parameters such as products, clients, field staff etc.. Although Al-FATEN supports it, data pertaining to financial projections, business analysis at the client level is not yet available. The system supports good access controls and has adequate back-up procedures, which ensure data security and limit data loss or manipulation.

The current accounting system is computerized but not integrated with the loan tracking system. The system generates all financial statements on a monthly basis, as well as analytical reports with financial ratios. The finance department conducts frequent reconciliation of cash and loan portfolio balances.

Although Al-FATEN has been sold to 4 other MFIs in the region, and while the IT staff at FATEN continue to provide technical support to these MFIs, the revenues generated from this as a percentage of total revenues is minimal. Additionally, with the lack of an extensive MIS manual and source-code for the system, there could potentially be a one-person risk. The MIS department is in the process developing a new system that takes into account integration of financial and accounting data and supports offline decentralization with branches.

In general, FATEN has one of the best information systems available in the region. Data and reports are generated in timely, accurate and frequent manner and could be designed to meet various needs.

6.7 Risk Management

FATEN has a good internal control system with opportunities for continued improvement. All basic procedures and internal controls are documented in various manuals and reports. Whereas all procedures are well understood by all staff, there exist notable inconsistencies in implementation as defined by the internal control reports.

FATEN separates duties for client selection, approval and recording of loan transactions to minimize potential fraud risk. All disbursements and repayments are made through partner banks, eliminating cash-handling risk. To limit credit risk, extensive group and individual client visits are conducted by several levels at the branches. Approval of loans is also done by a credit committee.

Although there are no stated controls for poor performance, FATEN actively monitors the employee performance, especially at the field level. Loan officer performance is measures on an ongoing basis as part of the portfolio management and incentive scheme.

An internal audit department was set up in 2004 with two knowledgeable staff members operating in Ramallah and Gaza and reporting directly to the Managing Director and the Board of Directors. The internal audit procedures are well documented by a manual that was recently developed by Price Waterhouse Coopers. The Internal Auditors follow an annual audit plan that is approved by the Board of Directors. They conduct periodic field visits to clients and branches and provide observations and recommendations pertaining to inconsistencies and gaps. The audit reports are submitted on a quarterly basis, and whereas they provide valuable recommendations for improvements, they have not been adequately followed through.

FATEN has eliminated cash handling risk by building strong relations with partner banks for all disbursements (made by checks to clients) and repayments. FATEN staff is not required to handle cash except for minor petty cash at the branch level.

6.8 Portfolio Quality and Provisioning

Table 12: Key Portfolio Quality Indicators

	2000	2001	2002	2003	2004	2005
# Active Clients	4,352	4,498	1,728	2,293	3,319	4,777
Outstanding Portfolio (EOP , US$m)	1.2	1.4	0.5	1.3	2.4	8.9
PAR >30 day	21.6%	7.2%	22.6%	3.2%	2.0%	1.6%
Write-off ratio[51] (>180 days)	0%	11%	24%	0%	0%	0%

Despite the difficult operating environment for FATEN, it has managed to keep a relatively clean portfolio. The portfolio quality took a dip in 2000 and 2002 following the second Intifada and the re-occupation of the West Bank by the Israeli Military Forces, but quickly recovered to regain its strength over the following three years. As a result of the 2002 events, the write off ratio jumped to 24%[52]. During this period, FATEN took several measures that contributed to the recovery:

- More stringent follow up on bad loans by field staff
- Significant slowdown of disbursement activity in 2002 to focus on collections
- Tighter client selection and tougher collateral and guarantee requirements

The improvement of loan portfolio quality notwithstanding, FATEN more than tripled its average loan size, focusing 75% of its portfolio on a smaller number of clients. This would prove to be a detrimental strategy for FATEN, as the unexpected government employee salary mayhem unfolded in the 1st quarter of 2006. FATEN is expecting to lose at least 10% of its portfolio if the salary crisis extends beyond the 2nd quarter.

Although FATEN has a good risk coverage ratio (150% on average) that is adequate enough to cover its losses, the decision to suspend the write-off policy might harm the institution if it is not amended to respond to the operating environment. The risk coverage ratio will need to be revisited in the emergency case scenario as the PAR (and loan losses) are expected to increase threefold.

As of April 30, 2006, the loan portfolio quality was beginning to get tarnished with the unfolding salary crisis. While PAR[53] (>1 day) was about 28% (affecting mostly the Housing and Family Loans), PAR >30 days still remained relatively low at 4% – this is expected to triple if the crisis remains to be unresolved over the coming 2-3 months.

Provisioning

FATEN applies a general provision of 3% on the performing part of its portfolio, or takes provisions on the MIS ageing report – whichever is higher. Based on discussions with senior management staff at FATEN, at least 10% of the portfolio is expected to be stricken off as non-performing loans following the salary crisis. FATEN management ensures that the write-off policy that was suspended in 2003 will be re-instated in 2006. The portfolio

[51] FATEN's Board made the decision to suspend the write-off policy as of 2003. The management is considering re-instating the write-off policy by end of 2006.
[52] FATEN has succeeded to recover at least 75% of this amount.
[53] The remaining balance of outstanding loans in arrears

quality of all MFIs operating in Palestine is expected to be adversely affected as the situation deteriorates. However, given the resilience and turnaround experience that FATEN staff has in the field, the portfolio is bound to recover in the medium run.

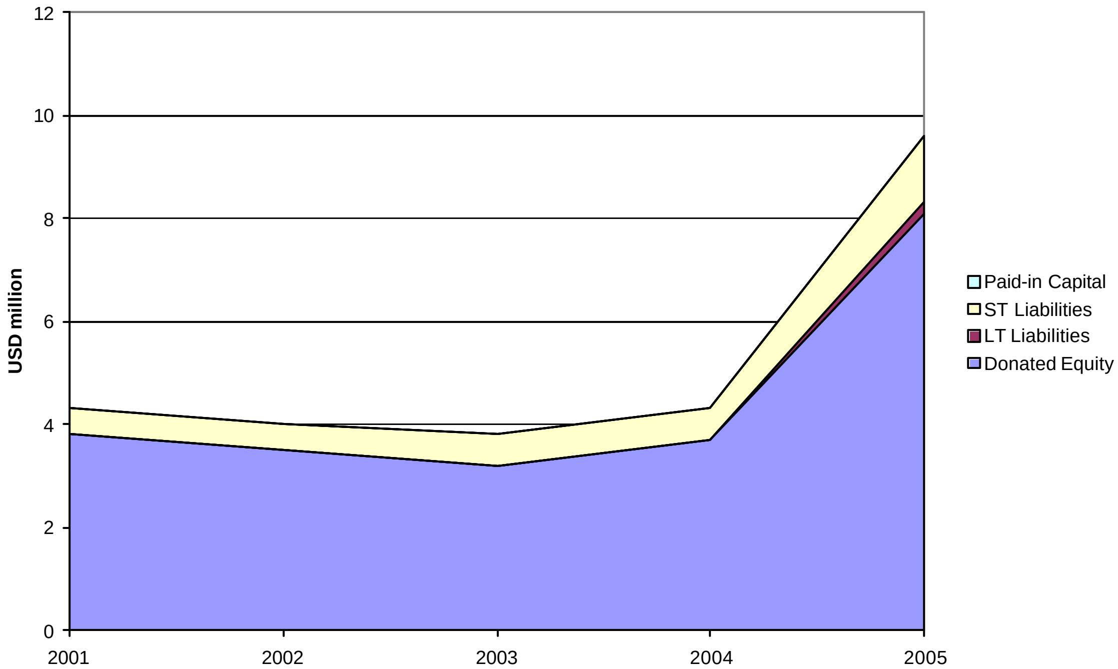
6.9 Funding and Liquidity

FATEN has been financed predominantly by donated equity provided by USAID provided through Save the Children for loan capital, fixed assets and operating expenses. During 2005, FATEN signed another grant agreement with USAID (through Save the Children) of USD 4.95 million to be fully injected by September 2006. In 2005 FATEN also received the first non-grant, a quasi-debt fund of USD 200,000 from the Islamic Development Bank. The term for the soft loan is 4 years, with 0% charge. This loan could be converted into equity at the end of the period.

With donor grant funds still abundantly available[54], FATEN will continue to tap into the grant funding market to finance its portfolio. FATEN management is also willing to explore commercial funding as a step towards establishing a credit history in the commercial market. This would be a very positive move toward diversification of funding sources, especially in light of the uncertainties governing donor intentions, policies and requirements.

FATEN invests 75% of its assets in it loan portfolio while maintaining the remaining portion in liquidity. In comparison to well performing MFIs, this is quite a low rate, and FATEN should seek to utilize its assets more efficiently in its loan portfolio.

Graph 17: Evolution of FATEN's Capital Structure (funding structure) in USD million



[54] UNDP and IDB are expected to pump 15 million into the market in as of 2006; USAID over US$20m.

Asset/liability Management Procedures

FATEN does not have any major risks regarding asset/liability management procedures. FATEN has relatively no long term liabilities – with the exception of the USD 200,000 IDB loan which is an insignificant 14.6 percent of total equity. Its portfolio is 70% short-term with approximately 30% of the portfolio in principal instalments due beyond 12 months. While almost all of the financing resources are long term in equity, FATEN has no potential maturity mismatches.

FATEN projects cash flows on a monthly basis for the year using the MICROFIN model developed by CGAP. Monthly disbursements and repayments are updates based on expectations from branches. Disbursements and repayments are set in specific days of the month in order to facilitate and monitor the cash flow process. FATEN certainly does not have a liquidity problem. In fact, it is over-liquid, which has prompted it to shift to less profitable loans (housing, family, NGO/Staff loans) in the past.

As a prudent liquidity measure, FATEN generally seeks to have cash on hand of not less than 5-10% of its portfolio. However, cash on hand since 2001 has averaged 25%. This rate is considered to be high by normal liquidity standards, but is understandably prudent following the Intifada crises periods and the increasing PAR. This can also be attributed to erratic donor behavior of pumping large cash disbursements with little understanding to the absorptive capacity of the institution.

This high liquidity level is expected to continue well into 2006 as a new crisis unfolds with the new government. Crisis notwithstanding, FATEN can afford to utilize its cash more efficiently towards its loan portfolio through developing a wider base for sector-specific products and new clients.

6.10 Efficiency and Sustainability

Table 13: Key Productivity and Sustainability Indicators

RATIO[55]	2003	2004	2005	Q1 2006	Formula
Productivity					
Staff Productivity	30	58	72	71	Active clients / total # staff
Loan Officer Productivity	65	111	129	133	Active clients / Total # Loan Officers
Profitability					
Avg. Outstanding loan/client	550	718	1,872	1,916	
Portfolio Yield[56]	24%	26%	19%	16%[57]	Portfolio revenue/13-month average gross outstanding portfolio
Operating Expense Ratio	97%?	47%	17%	8%[58]	Operating expense / 13-month average gross outstanding portfolio
Loan Loss Provision expense ratio	(22%)	(2%)	3%	n/a	Net loan loss expense / 13-month avg. gross OP
Outstanding Loan Portfolio/Total assets	23%	37%	74%	72%	Net portfolio/total assets
PAR (>30 days)	2.3%	0.9%	1.6%	4%	
Operational self-sufficiency	47%	66%	96%	117%	Total Operating Financial Income / Total Operating Expenses + Provision for loan losses
Financial self-sufficiency	44%	57%	73%	75%	Total Operating Financial Income / Total Operating Expenses + Cost of Funds

Efficiency

In comparison to peer MFIs in the region, and by international standards, FATEN has low productivity ratios. With its current staff structure, FATEN can handle a bigger caseload. Loan officers have on average a caseload of 110 clients, compared to a standard average of 250 clients. Despite an increasing volume of outstanding portfolio per loan officer, this does not necessarily reflect higher efficiency and wider outreach as the growth is a result of a significant increase in loan amounts to a smaller segment of clients.

[55] End of period, unless otherwise stated.
[56] Prior to the 2002 crisis, portfolio yield exceeded 45%
[57] Annualized
[58] Annualized

Operational and Financial Self-Sufficiency:
FATEN was at the brink of reaching operational sustainability (96%) by the end of 2005. This was quite a leap from 2003 figures with the operational sustainability stood at less the 50%. This improvement is due to an expansion in loan portfolio following the 2002 events, as well as a declining operating expense ration from a record high of 97% in 2003 to 17% in 2005. The reason for such high operating cost in 2003 was due to a conservative loan disbursement policy as well as the downscaling of outstanding loan portfolio in 2002. Additionally, FATEN maintained its loyal staff during this difficult period, which pressured the expense ratio further.

The difference between the operational and financial sustainability ratios for FATEN is notably high in 2005[59]. FATEN management considers a 12% cost of funds as a proxy when calculating the financial sustainability. Still, the differential is much wider than the cost of fund adjustment. This can be attributed to a substantial jump in portfolio growth (by more than 250%), while the concentration of loans shifted to lower yielding loans (family, consumption and housing), with APR roughly around 15% in comparison to a much higher yield on portfolio in the previous years (57% in 2001; 24% in 2003).

Portfolio Yield
Portfolio yield was relatively constant in the earlier years of operations, hovering at 54%, but took a considerable downturn to around 25% as the impact of the second Intifada and the reoccupation of the West Bank in 2002 seeped in. With the slowdown of lending activity and increasing loan defaults, the overall profitability dipped. The portfolio yield continued to drop considerably despite the rapid increase in portfolio growth. This was due to a shift in lending strategy focusing on larger loans with lower yields in response to donor pressure to disburse and to increasing competition from the microfinance and the formal banking sectors.

FATEN should monitor its portfolio yield carefully, as a continuing decline would have an adverse effect on the institution's sustainability. Efforts should be focused on increasing the volume of higher yielding loans and reducing the less profitable ones (such as NGO/Staff loans, housing and family loans).

Operating Expense Ratio
The operating expense ratio has dropped considerably, from 90% in 2002 to 18% in 2005 as the portfolio growth outpaced the growth in expenses over the same period.

Loan Loss Provision Expense Ratio
Barring the political events of 2000 and 2002, FATEN maintained a good quality portfolio, keeping the LLP ratio at check. The loan loss provision expense of 3%[60] is within the industry norm, but this is expected to triple should the political and economic situation worsen even further.

[59] FATEN management considers a 12% cost of funds as a proxy when calculating the financial sustainability.
[60] FATEN increased its LLR from (3% to 5%) or the aging report whatever is larger during the period 2000-2002 as a reaction to the intifada.

Profitability Outlook
FATEN's profitability outlook raises some concerns, as the profitability level is expected to decline further in the short run should the political and economic crises continue beyond the current level.

- A reduction in the interest rates charged to clients in case of a continued emergency scenario will bring down the portfolio yield even further.

- Operating expenses will increase as portfolio growth slows due to limited lending activity.

6.11 FATEN's Projections under Different Scenarios

FATEN has posed 2 scenarios for the next three years:

Normal-Conservative Scenario: No major or unexpected change in economic and political variables. Under this scenario, FATEN expects performance and activities to evolve with an average growth rate of 25%, while maintaining a clean portfolio with an average PAR >30 days of 2.5%. Given FATEN's high liquidity it would only need USD 2 million in additional funds for onlending.

Activity (year end)	2006	2007	2008
# Active Loans	6,600	8,554	10,137
Total Loan Portfolio (US$)	9.7m	12m	15m
% Portfolio Growth	--	23.3%	28%
PAR (>30 days)	2.3%	2.6%	2.7%
Loan Loss Reserve Ratio	3.2%	3.4%	3.6%
Loan Write-off Ratio	1.5%	1.5%	1.6%

Negative Scenario: Salary crisis continues beyond 4 months, disbursements come to a close halt and default sharpens as clients cease to pay due to lack of market liquidity. The entire Palestinian economy is hit. Under this scenario, there will be no real growth in clients or portfolio, with loan losses exceeding 10%. The impact of this scenario is expected to last for at least 24 months.

Activity (year end)	2006	2007	2008
# Active Loans	4,335	3,996	5,024
Total Loan Portfolio (US$)	8.5m	8.5m	9.8m
% Portfolio Growth	-5.4%	.10%	17%
PAR (>30 days)	10.3%	7.6%	4.5%
Loan Loss Reserve Ratio	10.3%	10.4%	10.6%
Loan Write-off Ratio	5%	3.5%	3%

In the case that FATEN would implement the proposed emergency new activity design, it would as a maximum require USD 4 million in funds for onlending. This calculation excludes FATEN's excess liquidity and is based on the assumption that all the 2, 668 GGLS clients and those clients taking the Individual I loan product (443) would be eligible (as they are assumed to have a household income of less than USD 600 monthly).

Chapter 7. Evaluation of CHF-ACP

7.1 Summary

Table 14: Market Position CHF-ACP[61]

Environment	Unregulated
Maturity	Mature: 11 years
Scale	Large: Portfolio of US$9.5m
Target Market	Broad (>100% GDP per capita)

Table 15: Key Performance Indicators CHF-ACP

	2003	2004	2005	31/03/2006
# of staff	27	23	32	32
Outstanding Loans	4,707,385	6,344,818	8,937,117	10,523,285
Active Borrowers	2,312	3,130	3,697	4,206
Percent Borrowers in Gaza	89%	82%	74%	71%
PAR (>30 days)	5.92%	2.64%	1.50%	2.35%
Risk Coverage Ratio[62]	6.88%	6.15%	10.23%	9.27%
Portfolio Growth	22%	35%	41%	18%
Operational Self Sufficiency	55%	93%	93%	NA
Financial Self Sufficiency[63]	33%	47%	53%	NA
Portfolio Yield	8%	9%	9%	NA
Staff Productivity	85	136	115	131

- **Key Strengths:** The Access to Credit Program (ACP) of CHF is an experienced and strong program in the area of house rehabilitation loans serving household living below or just above the poverty line. It has an unique loan product that is accompanied by engineering advice for the client concerning the construction work to be financed. ACP has a strong market position in this area and a well managed system for loan application, disbursement and follow up.

- **Areas for Improvement:** The ACP is yet a lending program implemented by a larger multi-facetted international NGO but has systems, people and CHF HQ commitment in place to transform (legally and institutionally) into a separate microfinance organisation under more stable political and economic circumstances. In order to achieve full financial sustainability – and independence from donor funds – product and target group diversification is essential (which ACP already started doing so) as the yield on the housing loan portfolio appears too low to cover all operational and financial costs.

- **Principal Risks (Emergency Scenario):** While CHF-ACP has had an excellent loan portfolio quality (with PAR > 30 days) less than 3 percent throughout the Intifada until

[61] Categories as defined by the MicroBanking Bulleting: Scale (outstanding portfolio US$): Large (> 8 million); Medium (2-8 million); Small (<2 million); Target Clientele (Average Outstanding loan/GDP per capita): Low-end: < 20% or average outstanding loan = US$150; Broad: 20% - 149%; High-end: 150% - 249%; Small Business: 250%

- Maturity (years of operation): New: 1-3 years; Young: 4-7 years; Mature: over 7 years.

[62] Risk coverage ratio: loan loss reserves/portfolio at risk (>30 days)

[63] Assumed imputed costs of funds is 8 percent

March 31, 2006, the portfolio at risk has increased in April. The PAR is expected to increase even more as all loan are guaranteed by salaries which have not been paid for the last few months.

7.2 Background

The Cooperative Housing Foundation (CHF) International – Palestine was registered according to Article 248 of the Companies Act of 1929 as an International Non Profit Making Organization, on December 14, 1995, to implement the Home Improvement Loans Program (HILP) in the Gaza strip. The successor of this program, PEOPLED, enabled CHF to expand into the West Bank first and later deepen its outreach in Gaza. The HILP grant has formally ended and CHF has started using HILP repayments to engage into small business finance.

Table 16: Overview USAID grants received by CHF for Home Improvement Lending

Source	***Date***	***Amount (US$) Total***	***Loan Funds***	***Contribution to operational costs***
1. USAID HILP	1995	5,022,935	4,000,000	1,022,935
2. USAID Peopled	Dec 2001	2,600,000	1,400,000	1,200,000
3. USAID Peopled	Aug 2003	2,000,000	1,605,586	394,414
4. USAID Peopled	April 2005	2,950,000	2,044,414	905,586
5. USAID Peopled	Sep. 2005	1,000,000	800,000	200,000
Total		**13,572,935**	**9,850,000**	**3,722,935**

CHF sees its lending program as a core operation and has used the USAID grants received for HILP and PEOPLED program to build a lending program that is well underway to achieve sustainability. CHF intents to continue providing the poor with access to finance and calls its lending program: Access to Credit Program (ACP). Although USAID has funded the program for over 10 years, this is the first time such an USAID evaluation takes place[64]. This evaluation will differ slightly from the evaluation of FATEN in the previous chapter for the following reasons:

- The core lending product of the ACP is home rehabilitation loans. The nature of this lending product ('larger' loans with a longer maturity) and the client – usually one time clients using household income to repay – are the reason that not all performance indicators applicable to microfinance can be customarily applied or used. Whenever this is the case, this will be noted in the report.
- CHF-ACP is a *program* and not an *institution*. Therefore ACP does not (yet) customarily measures ratios such as return on assets or return on equity. The evaluation did not adjust the balance sheet of CHF as this would have been a too theoretical exercise.
- The evaluation did assess whether ACP generated sufficient income to cover its costs. ACP does measure whether is covers its (operating) costs but does so without adjustments. These are done in this evaluation.

[64] It must be noted though that CHF HQ's Office of Development Finance conducts annual evaluations using an internally developed assessment tool, similar to ACCION's CAMEL and PlanetFinance's GIRAFFE.

CHF-ACP is a member of Palestinian Microfinance Network and the regional microfinance network Sanabel. Moreover it benefits from the CHF worldwide network of microfinance institutions.

7.3 Vision and Objectives

CHF mission:
CHF serves as a catalyst for sustainable positive change in low and moderate income communities around the world, helping to improve their housing, economic circumstances, and environments. CHF works with a wide range of organizations to develop systems, policies and practices that increase access to affordable housing, community services and finance. CHF believes that safe, affordable housing is the foundation upon which families can build a livelihood, a healthy community, and a peaceful, democratic society.

CHF ACP's main mission is to improve the living conditions of low and medium income families in the West bank and Gaza.

CHF ACP Objectives:

- Improve living conditions of low- and median-income Palestinians;
- Generate employment;
- Increase private sector involvement by encouraging banks' investment in the housing sector and to offer their financial services to people who wouldn't normally be a bank clientele;
- Stimulate the construction industry through its home improvement loans; and
- Achieve financial self-sufficiency and program sustainability.

CHF ACP vision:
CHF ACP envisions itself to be a sustainable financial institution able to provide healthy and suitable home to every family in Palestine especially to the low and median income and to reduce the number of families living under the poverty line.

- CHF ACP envisions itself making tangible improvement to people's lives in Palestine by improving their homes and by giving them small business loans.
- Reaching sustainability is not only a target but a means at the same time to increase outreach to more clients.
- CHF ACP envisions itself turning into a financial institution thus providing more variable financial services to more people in Palestine.

Since the start of the ACP, CHF has been committed to create a separate microfinance institution but has been prevented from doing so because of the political situation. CHF has substantial experience around the world with transforming its loan programs into separate institutions. Examples can be found in Jordan, Lebanon, Mexico and Bosnia. Usually it maintains an (equity) interest in the 'new' institution. This is a wise practice as it will ensure a continued commitment to the social mission and continued access to CHF worldwide network of microfinance affiliates.

7.4 Loan products

7.4.1 House Improvement Loans

The home improvement loans can be used for a variety of purposes and include amongst others: (i) skeleton works (such as building an additional room); (ii) finishing such as building a toilet, external sewage, internal sewage, kitchen, windows, doors, tiling/floors and rebuilding the roof (removing asbestos). Housing loans can also be used to purchase land or an apartment (for instance a family has saved a large part of the required amount and wants to borrow to purchase the last part). This hardly occurs though.

Eligible clients are households with monthly income of USD 200 – USD 1500. Not more than 1/3 of household income can be used for loan repayments. The maturity is up to 42 months with up to 3 months grace. The average maturity: is 36 months. ACP uses salary guarantees: depending on the loan amount 1 or 2 such guarantees are used. The interest rate on the loan to the final borrower ranges between 5.5 and 6.5 percent flat (per year). Three percent commission is taken upfront and deducted from the disbursed loan amount[65].

During the evaluation, it emerged that the use of certain English words concerning the home improvement loans, creates the image that the loans are for 'rich' people (or at least not so poor people). For instance the word 'finishing' in English creates the image that 'fancy' works are being implemented. However – client visits by the team and a review of client files, showed that 'finishing' for ACP means for instance tiling a floor (where before there would be dust), or building a toilet (where before there would be a hole in the ground). Also building an additional room (skeleton works) means for instance that a household of 12 people living in 2- 3 rooms get an additional room so that some household members (for instance a son with a wife and a baby) can have their 'own' space.

Also, a review of the client income statistics showed that almost two thirds (62 percent) of the home improvement borrowers live below or just above the poverty line (respectively 26 percent below, and 36 percent just above).

Table 17: Distribution CHF-ACP clients per household income category

Monthly Household Salary in USD	% borrowers
200 – 399	26 %
400 – 599	36 %
600 – 799	20 %
800 – 999	14 %
1,000 – 1,199	3 %
1,200 – 1,399	0 %
1400 – 1,499	0 %
Total	100%

[65] While in most other countries in the world, a commission would be charged one time up front – it is practice among Palestinian banks to charge commission annually – on the original loan amount! Hence if a bank quotes a one percent commission but the loan is for three years, the real commission charged is three percent flat and usually taken upfront. Clearly the Palestinian banks need regulation in the area of transparency in pricing and terms and conditions.

Although ACP has USD 15,000 as loan ceiling, average outstanding loan balance is USD 2,362 (year end 2005) and the average disbursed loan size is USD 4,700[66]. Average household income of ACP clients is USD 450 monthly.

The evaluation team proposed to ACP to change the name of the loan product into *home rehabilitation loan* as this captures much more the essence of the loan product.

ACP argues that its housing loans are different from housing loans offered by banks and other MFIs such as FATEN for the following reasons. First of all, ACP loans are accompanied by technical advice. ACP engineers visit a client up to 4 times, not only to ensure ownership of the property but also to assist the client with accurate cost estimates and construction advice. The engineer also makes visits to supervise the construction work. Second ACP targets the private sector, for instance employees of small businesses, small business owners and not government employees. ACP does use however government employees' guarantees. Last, ACP is very transparent about pricing and loan term and conditions.

The use of salary guarantees may exclude the poorest as these household may not have a member with a steady salary. However as noted before more than a quarter of ACP clients live below the poverty line. Already before the salary crisis and the increase in ACP's portfolio at risk, ACP staff has envisaged to revise the salary guarantee condition and also allow other types of guarantees such as post-dated cheques and promissory notes.

7.4.2 Small Business Loans

ACP started using funds that were made available for HILP after the end of this program to engage into small business lending. This program is still very small – there were 434 active clients year end 2005 – but ACP sees it as a promising area not only to generate more income but also to engage in target group and product diversification.

ACP offers working capital loans up to 24 months and fixed assets loans of up to 42 months – the average maturity is 30-36 months. The interest is 8 percent flat plus three percent commission which is deducted upfront from the loan amount. ACP requires one to two salaries as guarantee. The average disbursed loan amount is USD 4,900, and average outstanding balance is USD 3,700.

The CHF-ACP small business loans are higher than first time individual loans offered by other MFIs and hence a bit more risky as the borrower has no track record. The loans are smaller than small business loans offered by banks. ACP may have found a market niche but as we will see later, needs to improve its systems for loan appraisal and monitoring if it wants to achieve sustainable growth in this type of lending.

[66] FATEN's average disbursed housing loan size is USD 6,888

7.5 Cooperation with Banks

All loan disbursement and repayments are done through banks. CHF-ACP has two types of arrangements with banks: (i) a bank co-financing arrangement; (ii) a bank loan disbursement and repayment arrangement.

Bank co-financing arrangements – Partner Banks
Under this arrangement, the bank co-finances part of the loan and CHF-ACP shares interest and commission income with the bank. Almost 85 percent of all outstanding loans are made under this bank co-financing arrangement. CHF's partners are Cairo Amman Bank which co-finances 30 percent of the loan amount and Arab Bank which co-finances 35 percent of the loan amount. The banks are responsible for loan collection and monitoring while CHF is responsible for the (technical) application and loan request evaluation and the technical advice to the borrower.

Cairo Amman Bank by far is the most important partner of CHF-ACP: almost 51 percent of the number of active loans (and 52 percent of the volume) is through Cairo Amman Bank. As we will see later, the portfolio quality of loans made via Cairo Amman Bank is better than that of Arab Bank.

Cooperation Banks
CHF works with the Bank of Palestine, the Housing Bank and the Arab land Bank for disbursements of loans that it funds out of its own funds. As all loans are guaranteed by salaries (as is the case above), CHF pays the bank a 0.5 percent commission (on the original loan amount) per guarantor. Usually there are 2 guarantors and hence CHF pays the bank 1 percent commission. The Bank of Palestine – serving most of the government salary transfers – in the West Bank and Gaza, gets 2 percent. Payments are done via accounts payable. All interest and fee income are for CHF (5.5 percent flat for home improvement loans and 8 percent flat for small business loans).

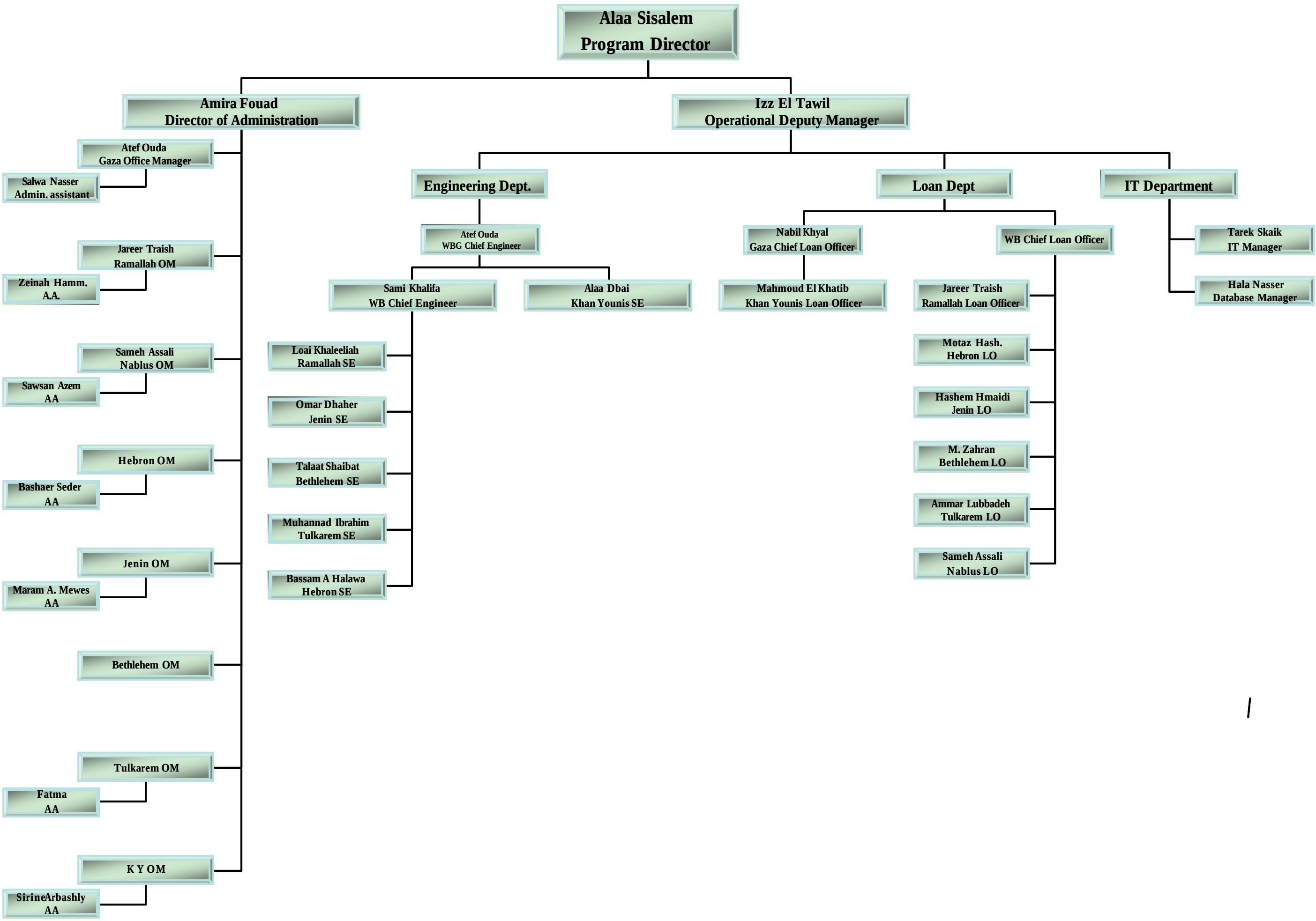
Loan Monitoring and Follow Up
CHF-ACP does not do an active follow up for the home improvement loans (only in case of default). It is developing procedures to systemize the follow up on small business loans. Such loans are followed up at least once after disbursement to see for instance in case of investment in equipment the equipment is actually bought. During the loan application process ACP loan officers do a site visit to ensure that the business actually exists. However there appears to be no system in place for regular follow up after the loan has been disbursed.

If a loan is made via a partner bank, the borrower has to open an account. Bank takes monthly the instalment due from that account. If account is empty, bank takes the next month from the guarantor.

If with cooperation bank: borrower pays into CHF account in this bank. Every day CHF-ACP receives bank reconciliations. If late, CHF-ACP sends memo to bank to deduct from guarantor salary after one month.

7.6 Governance, Management and Human Resources

Although set-up as a company – CHF Palestine is in effect and branch of CHF International, and as a result it reports via the CRO to CHF in Silver Spring and is part of annual budgeting, planning and other CHF procedures. CHF International is very committed to its operations in Palestine – this is partially reflected by the fact that the President of the Board of CHF has already visited WBG twice.



The ACP has a committed and dynamic management team, headed by the Program Director, Alaa Sisalem, who is based in Gaza. As about 75 percent of the clients are based in Gaza and because the ACP has its origins in Gaza, the heart of the operations – management and MIS – are also based in Gaza. The other members of the management team include the Operations Deputy Manager (COO), Izz El Tawil, who is based in the West Bank but visits the Gaza operations almost weekly, the Director of Administration - Amira Fouad, based in Gaza, and the Chief Engineer Atif Ouda, also based in Gaza.

The management team is fiercely proud of the 8 branches and considers each new branch a 'new baby' for the ACP. Each branch has a loan officer, engineer and administrative assistant who report to respectively the COO, chief engineer and head of administration.

Hence the head office management structure is 'copied' in the branches. The three key function, credit, engineering and administration work jointly on the lending program and are teams at branch level and HQ level.

Table 18: CHF-ACP Human Resource Overview

	y/e 2003	y/e 2004	y/e 2005	31/03/2006
Number of total staff end of period	27	23	32	32
Number of staff hired during period	12	6	12	1
Number of staff who left during period	4	7	3	2
Turnover rate; staff who left as percentage of average number of staff	15%	28.50%	11%	5.80%
Number of loan officers end of period	9	6	9	9
Loan officers as percentage of total staff	33%	26%	28%	28%
Number of admin staff end of period	14	12	14	15
Number of admin staff as % total staff	52%	52%	44%	47%
Number of line staff end of period	13	11	18	17
Annual loan officer salary	9,653	10,230	10,265	10,767
Annual loan officer other benefits	1,287	1,364	1,369	1,435
Total annual loan officer salary etc.	10,940	11,594	11,634	12,202

Staff turnover was high in 2004 as the PEOPLED grant had ended and some staff were insecure about the extension of the PEOPLED grant, especially in the West Bank. Hence a few staff left for other positions while some others took the opportunity to study abroad.

Total number of staff as of the end of March 2006 was 32 of whom 9 loan officers. This means that there are approximately 466 active clients per loan officer, a very high loan officer productivity. However given the nature of the loan product – packaged with engineering advice – the engineers should also be included in the productivity calculation. The more appropriate productivity ratio to use then is: (number of active clients)/(number of line staff): 4,206/17 = 247. This number is in line with the regional average of 232.

This appears to be still high and not in line with number of active clients per loan officer in other MFIs, which is much lower (150 active clients per loan officer is the Palestinian industry average).

It must be noted that the Palestinian loan officer productivity – measured as number of active clients per loan officer – is rather 'low' compared to regional standards. An important reasons for this is that given curfews, closures and (shifting) checkpoints it is difficult for the Palestinian loan officers to achieve productivity standards that are higher than the current 150.

The reason for the 'high' productivity of CHF loan officers may have to do with the nature of the majority of the loans – home improvement loans, guaranteed by salaries. Such loans and borrowers – as opposed to micro and small business loans – require less follow up and monitoring. Once the loan is disbursed and once the engineers have checked that the (re-) construction has been implemented, loan officers do not visit the clients anymore. While for a 'normal' MFI it is important to build a relationship with the client as the client wants continued access to finance, the home improvement borrowers are mainly one-time borrowers. Less than 5 percent comes back for repeat loans. With the planned for increase in small business lending, it can be expected that the loan officer 'productivity' of CHF will decrease as such borrowers will require regular visit (and hence will consume more of the loan officer's time).

The loan officers are (very) well paid – annual salary including benefits – amount to about 10 times the GDP per capita – compared to 4 – 5 times GDP per capita in the Arab region. The CHF loan officers do not receive bonuses. Again, with the expected increase in small business lending, CHF may consider introducing incentives based on loan portfolio performance.

7.7 Planning, Audit and MIS

Planning and Budgeting

Planning and budgeting are both iterative processes. The management team of CHF-Palestine prepares an annual budget and plan which is then discussed with technical departments in CHF HQ (such as the Development Finance Department) as well with the CHF financial and administrative departments. Budget and plan are approved finally by a Committee in HQ. There are sometimes revisions but always in discussion with CHF-Palestine. HQ does not impose its views.

The Development Finance Department in the HQ has a full-time staff of five microfinance and banking experts and manages and provides technical assistance to CHF microfinance programs around the world.

HQ has to approve major operational decisions concerning the ACP such as the introduction of new loan products, but also decisions that would affect the sustainability of ACP (such as lowering the interest rate). CHF-P considers its colleagues in HQ very much as part of the team.

Audit

Internal Audit. CHF-ACP employs an internal auditor, who reports to the ACP manager. This auditor checks whether proper procedures are adhered to, and also does site visits. The auditors checks also bank reconciliation forms etc. There is also a regional CHF internal auditor for the Middle East Region who reports to the CHF headquarter.

External Audit.. The external auditor – Talal Abu Ghazaleh & Co. does the annual audit and reports to Board of CHF at HQ in Silver Spring. CHF HQ is also audited by an external auditor who has access to all files of CHF Palestine if needed.

ACP also provides monthly lending and financial statistics to the HQ ensuring regular monitoring and control.

MIS

CHF-ACP has developed its own loan tracking system. This system can generate a variety of reports. However CHF-ACP only tracks the number of loans disbursed. For critical information on the key source of income i.e., the loan portfolio outstanding, CHF-ACP is dependent on the banks, which all implement loan portfolio monitoring software including aging of arrears developed by CHF. Yet CHF has no online data available on the portfolio outstanding (and arrears) and depends on the banks to submit monthly overviews.

Not being in control of such a key piece of management information is not sustainable and CGF-ACP is recommended to find ways to have this information available on line as soon as possible.

CHF is in the process of developing internally a web-based MIS system that would amongst others address the issues mentioned above. This MIS is currently successfully implemented with CHF in Romania.

7.8 Loan Portfolio Quality and Provisioning

Table 19: CHF-ACP Key Loan Portfolio Quality Statistics

	Y/E 2003	Y/E 2004	Y/E 2005	31/03/2006
Home improvement loans				
Loan portfolio outstanding	4,681,075	6,183,575	8,071,263	8,909,647
Number of active clients	2,308	3,086	3,449	3,772
Average outstanding balance	2,028	2,004	2,340	2,362
Average amount disbursed (initial loan)	4,604	4,619	4,644	4,700
Loan losses written off over the period	4,575	8,480	2,388	6,505
Increase in LLR over the period	- 6,107	- 11,263	8,004	4,715
On time and never rescheduled	4,037,153	5,813,862	7,332,829	8,058,041
1-30 days	365,149	202,335	604,767	660,640
30-60 days	213,310	126,799	107,392	145,584
60-90 days	45,286	32,104	5,999	18,873
91-180	16,529	8,475	13,693	19,801
180-360	3,648	-	6,583	6,708
360+	-	-	-	-
PAR > 30 days	278,773	167,378	133,667	190,966
PAR > 30 days as % of LP outstanding	5.96%	2.71%	1.66%	2.14%
Small Business loans				
Outstanding principal balance	26,310	161,243	865,854	1,613,638
Number of active clients	4	44	248	434
Average outstanding balance	6,578	3,665	3,491	3,718
Average amount disbursed (initial loan)	6,825	5,510	4,683	4,922
Loan losses written off over the period	0	0	0	0
Increase in LLR over the period	-	40	274	6,441
On time and never rescheduled	26,310	157,243	834,474	1,414,985
1-30 days	-	4,000	31,380	142,245
30-60 days	-	-	-	42,643
60-90 days	-	-	-	6,659
91-180	-	-	-	4,641
180-360	-	-	-	2,465
360+	-	-	-	
PAR > 30 days	-	-	-	56,408
PAR > 30 days as % of LP outstanding	-	-	-	3.5%
ALL LOANS				
Outstanding principal balance	4,707,385	6,344,818	8,937,117	10,523,285
Number of active clients	2,312	3,130	3,697	4,206
Average outstanding balance	2,036	2,027	2,417	2,502
PAR> 30 days	278,773	167,378	133,667	247,374
PAR>30 days as % LP outstanding	5.92%	2.64%	1.50%	2.35%

As of March 30, 2006, the loan portfolio quality was still relatively good despite the evolving salary crisis. While the portfolio at risk over 1 day – defined as remaining balance of outstanding loans in arrears for more than one day – was about 10 percent (9.5

percent for the home improvement loans and 12.3 percent for the small business loans), the portfolio at risk over 30 days was only 2.35 percent, showing the effect of the deductions of required instalments from the salaries of the guarantors which take place one month after a loan has gone into arrears. This was however the status of March 30, 2006. In April, the portfolio at risk over 30 days had already increased to 7 percent showing that there were no salaries to deduct from. The portfolio at risk over 1 day had increased to 30 percent. Since April CHF-ACP has not made new loans.

CHF-ACP has had and is having extensive internal discussion on how to cope with the evolving crisis. Fortunately both CHF has extensive experience in dealing with crisis in (post-) conflict environments including Iraq and Afghanistan, and ACP staff is confident that the quality of its portfolio will return to its normal high level once the crisis passes. For now, like the banks and other MFIs, CHF-ACP is not pressuring borrowers to repay because of the salary crisis.

Loan portfolio quality differs widely among the different partner and other banks. The banks that co-finance the loans are clearly better performing (as they have their own funds at stake also) with Cairo Amman Bank doing better than Arab Bank.

Table 20: Key Bank Statistics

	Number of active loans	% of all active loans	Loan Portfolio Outstanding	PAR> 30 days as % of LP Outstanding
Partner Banks				
Cairo Amman Bank Home Loans	2,116	50%	4,691,629	0.53%
Cairo Amman Bank Small Business Loans	260	6%	749,333	1.08%
Total Cairo Amman	*2,376*	*56%*	*5,440,962*	*0.61%*
Arab Bank Home Loans	1,163	28%	2,134,224	3.36%
Total Partner Banks	**3,539**	**84%**	**7,575,186**	**1.38%**
Cooperation Banks				
Housing Bank Home Loans	48	1%	243,540	0%
Housing Bank Small Business Loans	24	1%	120,852	15.29%
Bank of Palestine Home Loans	351	8%	1,553,152	4.05%
Bank of Palestine Small Business Loans	141	3%	704,022	2.91%
Arab Land Bank Home Loans	94	2%	287,102	10.98%
Arab Land Bank Small Business Loans	9	0%	39,431	23.82%
Total Cooperation Banks	**667**	**16%**	**2,948,099**	**4.84%**
Total Home Loans	**3,772**	**90%**	**8,909,647**	**2.14%**
Total Small Business Loans	**434**	**10%**	**1,613,638**	**3.34%**
Total All	**4,206**	**100%**	**10,523,285**	**2.33%**

Clearly the Arab Land Bank and the Housing Bank are not well performing but they have few loans outstanding. CHF should monitor the performance of its partner banks closely and could consider changing the fee and commission arrangements with these banks based on their performance.

Provisioning
CHF Palestine has convinced the CHF headquarters to apply an aging of arrears provisioning schedule which is less conservative than CHF's worldwide practice for provisioning. CHF Palestine provisioning percentages are based on historical data – and given the high loan portfolio quality the resulting provisioning is lower than CHF worldwide. It is also lower than the practice of other MFIs in the West Bank and Gaza. CHF also does not apply a general provision on the performing part of its portfolio, which would be prudent to do under the current political and economic circumstances. Although today (May 2006), CHF has no adequate provisions, it plans to increase its provisions in the very near future.

Table 21: CHF Palestine provisioning schedule compared with CHF worldwide and MF sector in WBG

Days in arrears	CHF Palestine	CHF Worldwide	MFI sector Palestine
1 – 30	1 %	10 %	10 %
31 – 60	4 %	30 %	30 %
61 – 90	10 %	30 %	30 %
91 – 180	15 %	60 %	60 %
181 – 360	100 %	100 %	75 %
360>			100 %

As we will see later, the adjusted profit and loss account of CHF will incorporate adjustments made to the provisioning levels of CHF (i.e., increases).

7.9 Financial Statements

Profit and Loss Account
The CHF annual statements are prepared according to auditing standards accepted in the United States and to standards applicable to financial audits contained in the Government Audit Standards issued by the Comptroller General of the United States. The most important feature of these standards is that income is accounted for when received and expenses are accounted for when paid.

These accounting standards – combined with the fact – that CHF Palestine is engaged in more activities than only the ACP – make it difficult to reflect the true status of the ACP as a *'going concern'*. Therefore during the evaluation adjustments were made to the P&L to arrive at a more realistic estimate of costs and income of the ACP. Fortunately the US Government Audit standards are very detailed – especially the footnotes – so the task to 'take out' the income and expenses of the ACP was not too difficult. The unadjusted financial P&L is attached in Annex 2. The following adjustments were made to arrive at a more realistic cost and income picture: (i) only income (fees, interest, commission) that could be attributed to ACP was included; (ii) only expenses that could be fully attributed to ACP (i.e., HILP and PEOPLED expenses) were included.

Then another set of adjustments was made to assess ACP's ability to sustain itself. Two ratios were calculated: (i) the operational self-sufficiency (OSS) which is the ability of ACP to cover operational expenses defined as administrative costs and costs of loan loss provisioning out of interest and fee income; and (ii) the financial self-sufficiency (FSS) of ACP – the ability of ACP to cover not only its operational costs as described above but also its costs of capital (costs of funds).

The adjustments made were as simple as possible because the purpose of the exercise was to gain an impression whether ACP was (underway towards) covering its costs and hence being able to sustain its own operations.

Table 22: CGF-ACP P&L after different sets of Adjustments

P&L After First Round of Adjustments	**Sept. 30, 2003**	**Sept. 30, 2004**	**Sept. 30, 2005**
Income			
Interest income on loans	306,459	381,559	482,123
Commission income	49,707	91,796	131,034
Fee income	-	52,119	75,530
Total Income	**356,166**	**525,474**	**688,687**
Expenses			
PEOPLED expenses	579,395	489,069	597,605
HILP expenses	19,991	13,501	51,068
Bad debt expenses	19,481	20,652	12,560
Total Expenses	**618,867**	**523,222**	**661,233**
Income over Expenses	**- 262,701**	**2,252**	**27,454**
Additional Adjustments - Additional Expenses			
A. Loan loss provisioning			
Addition to General provision (3%)	30,557	44,104	77,660
OSS	**55%**	**93%**	**93%**
B. Cost of Funds			
Imputed costs of funds (12%)	648,000	840,600	840,600
Imputed costs of funds (8%)	432,000	560,400	560,400
Imputed costs of funds (3%) - inflation only	162,000	210,150	210,150
FSS (costs of funds 12 percent)	**27%**	**37%**	**44%**
FSS (costs of funds 8 percent)	**33%**	**47%**	**53%**
FSS (costs of funds - inflation only)	**44%**	**68%**	**73%**
Memo LP outstanding: Sept. 2002	*Sept. 2003*	*Sept. 2004*	*Sept. 2005*
3,841,415	*4,859,978*	*6,330,101*	*8,918,754*
Average LP Outstanding	*4,350,697*	*5,595,040*	*7,624,428*
Memo Grants Received for Onlending			
HILP - ended 1997	4,000,000	4,000,000	4,000,000
PEOPLED I - 2001	1,400,000	1,400,000	1,400,000
PEOPLED II - 2003	-	1,605,000	1,605,000
Total	5,400,000	7,005,000	7,005,000

Loan loss provisioning

In addition to the real additions to the loan loss reserve (booked by CHF under bad debt expenses) an additional 'general' provision is made on annual (incremental) increase of the loan portfolio outstanding in order to reflect the high risk environment in the West Bank and Gaza.

As is shown below, with the additional increase in loan loss reserve, expenses go up. The Operational Self-Sufficiency of CHF-ACP would then have been 93 percent at the end of September 2005. This is a very good achievement – as the ACP would almost be fully operationally sustainable, and compares favourably with other MFIs in the West Bank and Gaza.

Cost of funds adjustment
However, as is the case with all the other MFIs in the West Bank and Gaza, CHF-ACP is far from being financially sustainable. In order to calculate the financial self-sufficiency ratio we try to calculate what CHF-ACP would incur in additional financial expenses if it would have to borrow for onlending. Hence we assume that ACP would not have had USAID grants for onlending but would have borrowed these amounts on the local market.

The USD 2,044,000 grant that CHF in 2005 is excluded from these calculations as this grant arrived very late in the year 2005 and hence did not materially affect the P&L as of September 30, 2005. The same is the case for an USD 800,000 grant which was signed with USAID in September 2005 (please refer to section 7.1 for grant overview).

If we would assume that the local borrowing costs would be 12 percent – an assumption made by FATEN, the CHF FSS would have been 44 percent end of September 2005.

CHF-ACP is currently negotiating with Cairo Amman Bank an USD 1-2 million overdraft account for 7 percent. This could be a proxy for the real local costs of funds. We can assume however that such costs of funds could be higher if the overdraft is for a higher amount (or if the overdraft becomes a loan). Assuming then a cost of funds of 8 percent, the FSS would be 53 percent.

Finally, some experts in the world of microfinance would argue that the financial expense adjustment made above is not fair, as the USAID grant can be considered so-called donated equity and equity is usually 'cheaper' than borrowed funds. These experts would argue to only do a so-called inflation adjustment on the grants received as the MFI would want to maintain the real value of its donated capital. If we assume an inflation rate of 3 percent – as cost of fund adjustment – the FSS of ACP would increase to 73 percent.

Evaluation
There is a large difference between the OSS and FSS: if we would use 8 percent as imputed costs of funds, the difference is 40 percent. An important reason is the fact that the (nominal) yield – the financial revenue (interest and fees) from the loan portfolio as a percentage of the average outstanding loan portfolio – is a very low 9 percent. The regional average is about 38 percent[67]. The yield of CHF-ACP is even lower than that of an average commercial bank in the region. Banks can afford lower yields because they have very high volumes outstanding. However this is not the case of CHF-ACP.

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[67] It must be noted though that the average MFI in the region is engaged in microfinance and not in home improvement lending. Micro enterprises are highly profitable and can afford high interest rates.

Despite CHF's very high operational costs per staff member – over USD 20,000 and perhaps the highest in the Palestinian microfinance sector, the operational expenses as percentage of average dollar outstanding are low, compared to the sector – even after adjustments (respectively 9 percent before adjustments and 17 percent after adjustments). The regional average after adjustments is 30 percent.

Clearly CHF-ACP faces the challenge to generate more income from each dollar outstanding if it wants to achieve financial sustainability. Its move into the direction of higher yielding small business loans will contribute to higher income.

The issues of sustainability and product pricing have been a concern of CHF HQ for some time. A CHF internal assessment was planned for earlier this year but was postponed because of the situation. Part of this assessment is to look at sustainability, pricing and business planning for the future. The assessment will also look into the options to transform the ACP into a separate financial institution.

7.10 ACP Ideas for Loan Products during the Emergency Period

ACP staff had internal brainstorm discussions on how to deal with the evolving crisis. One of the outcomes of these discussion included the introduction of a series of 'emergency loan products'. These yet have to be discussed and finalized with CHF HQ and are hence tentative in nature only. Below follows an overview of some of the loan product concepts discussed right now.

Rehabilitation Loans

Loan purpose:	Provide families living under the poverty line with rehabilitation loans. It is expected that the demand for such loans will be high due to the fact that many families who are living in rental apartments will not be able to pay the rent (due to liquidity constraints) and will move into the home of their family and as a result needing loans to add an extension such as a room.
Eligibility:	Families with monthly income not exceeding USD 400
Loan amount:	USD 2000 – 4000, with monthly repayment not exceeding more than 1/3 of a household's income. The expected average loan size is USD 3500
Grace period:	Up to 6 months (depending on the duration of the emergency period)
Repayment period:	24 – 36 months
Interest rate:	Between 0 – 3 percent flat
Commission	Between 0 – 3 percent flat

Bridging Loans to Current Active Clients

Loan purpose:	Provide emergency financial services to families living under the poverty line. This back up loan will be offered to existing clients who need a loan to cover their humanitarian needs. The loans will be kept in different accounting books and will be considered as a second outstanding loan to the client.
Eligibility:	Families with monthly income not exceeding USD 400
Loan amount:	USD 1000 – 2000; the average expected loan size is USD 1500
Grace period:	6 months

Repayment period:	12 – 36 months
Loan repayments:	Not more than one third of the monthly income
Interest rate:	Between 0 and 3 percent flat
Commission:	Between 0 and 3 percent flat

Bridging Loans for New Clients

Loan purpose:	Provide emergency financial services to families living under the poverty line.
Eligibility:	Families with monthly income not exceeding USD 400
Loan amount:	USD 1000 – 2000; the average expected loan size is USD 1500
Grace period:	6 months
Repayment period:	12 – 36 months
Loan repayments:	Not more than one third of the monthly income
Interest rate:	Between 0 and 3 percent flat
Commission:	Between 0 and 3 percent flat

Small Business Loans

Loan purpose:	Provide emergency financial services to micro and small businesses to overcome lack of liquidity problems by providing additional working capital. The purpose of the loans is to enable these businesses to continue operating and not go bankrupt. Such businesses will be able then to continue to sell their good and to accept that their clients would buy on credit for a longer period.
Loan eligibility:	Micro and small businesses providing essential needs for the community.
Loan amount:	USD 2000 – 4000; the expected average loan size is USD 3000
Grace period:	Up to 6 months
Repayment period:	12 -24 months
Interest rate:	Between 0 and 3 percent flat
Commission:	Between 0 – and 3 percent flat

Table 23: Estimated disbursement over a 6 month emergency period (October 2006 – March 2007)

	Total number to be disbursed	Value to be disbursed (in USD)	Number of beneficiaries
Rehabilitation loans	880	3,080,000	4,400
Bridging loans to existing clients	480	720,000	2,880
Bridging loans to new clients	600	900,000	3,600
Small business loans	410	1,230,000	2,050
Total	**2,370**	**5,930,000**	**12,930**

The team believes that CHF's proposed loan products are realistic. The objectives of CHF's proposed emergency loan products are similar to the objectives of the new activity design proposed by the team. However the team questions the proposed small business loan as it remains to be seen whether these business will have any capacity to repay. Also the proposed loan ceiling for the bridging and rehabilitation loans appears high. If we would exclude the proposed small business loan, CHF would require USD 4.7 million in funds for onlending.

If CHF were to implement the emergency case loan program as proposed by the team, up to 2,600 clients would be potentially eligible as 62 percent of CHF clients has a household income of less than USD 600 monthly. CHF would then require up to USD 3.9 million in funds for onlending.

Under the normal case scenario, CHF needs USD 6 million in further funds for onlending in order to achieve operational and financial sustainability.

Box 9: CHF experience with 'emergency lending'

After the invasion, USAID 'convinced' CHF to accept a grant of USD 150,000 to make soft loans in Beit Hanoun where many homes were damaged etc.

CHF developed a loan product which comprised of a 25 percent grant. People taking the loan considered is like an Islamic urgency loan (*Al Qard Al Hassan*) without interest. CHF developed criteria on who was (most) eligible and succeeded in assisting 160 households (about USD 1000 each). The 'news' on the soft loan was widely announced in order to maintain transparency and people themselves also decided on who was most eligible. Criteria included: beneficiary should be a client of CHF and the loan amount that the beneficiary can afford (i.e. based on household CF) does not cover the basic shelter-needs (sewage, toilet etc.).

CHF first did not want to be involved as it was afraid for its image on credit and repayment discipline. People however saw it as an interest free loan, and were grateful and the project ended up enhancing customer loyalty. CHF would do it again – with hindsight it was a good experience.

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C. Specific Documents on MFIs

CHF

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- Articles of Association/Statutes

FATEN

- FATEN Annual Report 2003
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- FATEN Annual Report 2005 (draft)
- FATEN PlanetRating Report, April 2006
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- Articles of Association
- SWOT Analysis Report 2006

Others

- ACAD PlanetRating Report, April 2006
- Alrafah PlanetRating Report, April 2006
- PARC 5- year strategic business plan (2005-2010)
- UNWRA MMP Program – Medium Term Plan (until year end 2009)

Annex 1: Meeting List

A. Donors

USAID
Dennis Sharma, Director Private Enterprise Office
Fadi Abdellatif, Project Management Specialist, Private Enterprise Office
Barbara Belding, General Development Officer
Robert Burke, Trade and Economics Advisor
Amir Dajani, Aid Development Assistance Specialist
Elias Khayyo, Program Development Specialist

PlanetFinance
Delphine Thizy, Country Representative Palestine
Daniel Sorrosal, Director (Paris)

UNDP
Minna Tyrkko, Deputy Special Representative
Hiba Qasa Barakat, Programme Management Officer, Sustainable Human Development

World Bank/IFC
Youssef Habesch, IFC Country Officer, Middle East and North Africa
Khaled Walid Qutob, Program Officer, Financial Markets, Middle East and North Africa
Husam Abu Dagga, World Bank, Senior Operations Officer
John Wetter, Chief Economist (based in Washington DC)

KfW/European Palestinian Credit Guarantee Fund
Hanna Sahhar, Manager
John Khoury, Director

EIB European Investment Bank
Nabil Abu Diab, Consultant

IDB Islamic Development Bank
Nabil Abu Diab, Consultant

Portland Trust
Samir Huleileh, Director

B. Microfinance Institutions/Programs

ACAD
Samir, Barghouthi, Executive Director
Ashraf Al-Zein, Operations Credit Manager

Alrafah Microfinance Bank
Sami Saidi, General Manager
Hind Aloul, Development and Planning Department

ANERA
Dr. Thomas Neu, Middle East Representative
Mazen, Dabbagh, Credit and Finance Consultant, IFAD Programme Manager

ASALA
Reem Abboushi, Executive Director

CHF
Lana Abu Hijleh, Country Director West Bank and Gaza
Alaa Sisalem, ACP Director and CFO CHF West Bank and Gaza
Izz Tawil, Operations Deputy Manager
Amira Fouad, Director of Administration
Atif Ouda, Chief Engineer
Hussein Yassien, Manager POWER Program

FATEN
Anwar Jayousi, Managing Director
Faris Abdelnour, Finance and Administration Manager
Fawz Abu Hijleh, Operations Manager
Suleiman Rantisi, MIS Specialist
Ihab Rantisi, Internal Auditor
Credit Supervisor Ramallah Branch
Loan Officer Ramallah
Naser Abdul Karim, Chairman of the Board

Palestinian Microfinance Network
Reem Abboushi, Chairwoman
Samir Barghouthi, Former Chairman

PARC
Ismail Daiq, Director
Rula Nesnas, Manager

PBC
Khaled Masood, Credit Manager

UNWRA – MMP
Alex Pollock, Director
Jane Giacaman, Manager

YMCA
Adnan Shalaldeh, Project Coordinator
Hathan Hammory, Credit Unit Manager
Basel Jarrar, Ramallah District Officer

Annex 2: Founding Members of Alrafah Bank

Founders of Alrafah Microfinance Bank	Amount of Shares ($)	%
PALESTINIAN TELECOMMUNICATION CO.(PALTEL)	2,000,000	6.70%
PALESTINIAN DEVELOPMENT & INVESTMENT CO. (PADICO)	2,000,000	6.70%
LOTUS FOR FINANCIAL INVESTMENTS CO.	2,000,000	6.70%
BIRZEIT FOR MEDICAL CO.	1,000,000	3.40%
TRUST INTERNATIONAL INSURANCE CO.	1,000,000	3.40%
GAZA FOR INVESTMENT AND DEVELOPMENT CO.	1,000,000	3.40%
AREF MASOUD NAQFI	1,000,000	3.40%
FUAD ABED AL HADI MUSHAL	500,000	1.70%
ABED RABUH YOUSEF DAHLAN	500,000	1.70%
TALAL KATHEM NASIR EL DIN	400,000	1.30%
ROBERT C SAGER	300,000	1.10%
NABEEL SEEF ELDIN NASIR ELDIN	250,000	0.80%
ABED ALMALEK JABER	100,000	0.30%
KHALIL SALIM HANANIAH	100,000	0.30%
BASSAM SALIM HANANIAH	100,000	0.30%
Total Amount Founding Shareholders	**12,250,000**	**41.20%**
OTHER SMALL SHAREHOLDERS (around 19,000)	**17,750,000**	**58.80%**
Total All	**30,000,000**	**100%**

Annex 3. Key Statistics ProCredit Bank Network

	# loans disbursed in December 2005	Amount disbursed in December 2005 (EUR)	Average loan amount granted (EUR)	# loans outstanding year end 2005	Arrears > 30 days as % of average loan portfolio outstanding
Georgia (USD)	5,494	17,503,702	3,186	38,074	1.44%
Bosnia (EUR)	2,942	9,718,095	3,303	29,371	0.75%
Albania (EUR)	1,746	6,295,559	3,606	29,123	2.45%
Kosovo (EUR)	2,671	20,311,596	7,604	41,592	0.55%
Ukraine (USD)	3,688	22,385,982	6,070	28,714	0.64%
Romania (EUR)	1,641	10,747,046	6,549	21,283	1.18%
Moldova (USD)	1,736	2,761,544	1,591	10,790	1.15%
Serbia (EUR)	5,999	33,385,542	5,565	48,622	0.65%
Bulgaria (EUR)	3,081	25,184,999	8,174	38,442	0.51%
Macedonia (EUR)	1,636	8,623,255	5,271	12,781	0.69%
Bolivia (USD)	6,385	10,593,833	1,659	80,201	1.67%
Nicaragua (USD)	5,773	5,419,444	939	58,117	1.69%
El Salvador (USD)	6,745	5,403,938	801	66,617	1.71%
Ecuador (USD)	2,817	6,253,050	2,220	30,974	0.99%
Haiti (USD)	1,302	1,121,629	861	8,488	5.46%
Mozambique (USD)	1,942	1,187,130	611	15,587	1.81%
Ghana (USD)	699	977,114	1,398	6,226	4.51%
Angola (USD)	132	602,659	4,566	1,093	2.26%
Congo (USD)	113	495,383	4,384	674	0.00%
Total	**56,542**	**188,971,502**	**3,342**	**566,769**	**1.06%**
Subtotals					
Eastern Europe	30,634	156,917,320	5,122	298,792	0.87%
LAC	23,022	28,791,895	1,251	244,397	1.63%
Africa	2,886	3,262,286	1,130	23,580	2.60%

Annex 4 A. Bank Terms and Conditions for Savings

SAVINGS	Arab Bank	Cairo Amman Bank	Bank of Palestine	Bank of Jordan	Arab Islamic Bank	Egyptian Arab land Bank	Palestinian Investment Bank
Is there a minimum?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
If yes, how much?							
In JD	100	100	100	100	70	20	100
In NIS	Equal to 100JD	700	500	500	450	100	650
In USD	Equal to 100JD	150	100	100	70	25	150
Interest rates received	1.02	0	0.5	0.7	Profit	0.5	0
Penalties							
Withdrawel before due time	loosing interest accured during the month	No	loosing interest accrued during the month	loosing interest accured during the month	No	loosing interest accured during the month	No

Annex 4 B: Bank Terms and Conditions for Terms Accounts

TERM ACCOUNT	**Arab Bank**	**Cairo Amman Bank**	**Bank of Palestine**	**Bank of Jordan**	**Arab Islamic Bank**	**Egyptian Arab land Bank**	**Palestinian Investment Bank**
Is there a minimum?	Yes	Yes	Yes	Yes	Yes	Yes	
If yes, how much?							
In JD	3500	3000	1000	500	3500	3500	2000
In NIS	25000	10000	5000	5000	22500	25000	10000
In USD	5000	5000	1500	1000	5000	5000	10000
Interest rates received							
1- month ($),(JD),(NIS)	(2.65),(2.15),(2)	(3.26),(3),(3.28)	(3.25),(3.37),(3.37)	(1.4),(1.5),(1.4)	See note	(1.3),(1.59),(1.4)	(1.75),(1.50,(1.75)
($),(JD),(NIS)	(2.8),(2.2),(2.1)	(3.4),(3.1),(3.33)	(3.37),(3.5),(3.50)	(2),(1.8),(1.5)		(1.5),(1.84),(1.5)	(2),(1.75),(1.87)
3-6 months ($),(JD),(NIS)	(3.15),(2.35),(2.15)	(3.37),(3.2),(3.41)	(3.37),(3.5),(3.50)	(2),(2),(1.7)		6)	(2.12),(2),(2)
up to 1 year $),(JD),(NIS)	(3.3),(2.45),(2.45)	(3.5),(3.4),(3.57)	(3.5),(3.62),(3.62)	(3),2.5),(2)		)	(2.5),(2.25),(2.12)
18 months ($),(JD),(NIS)	No for more I year	No	No	No		(2),(2.2),(1.70	
24 months ($),(JD),(NIS)	No for more I year	No	No	No		No	
36 months ($),(JD),(NIS)	No for more I year	No	No	No		No	
violation							
1- Amount less than minimum	Converted to saving or current account	2% deduction from interest due	No	No	No		Lossing interest for remaining period
2-withdraw befor due time	Loosing interest gained during the month	2% deduction from interest due	No	0.5 % penalty	No profit	Loosing interest gained during the month	lossing interest

Annex 4 C: Bank Terms and Conditions for Current Accounts

CURRENT ACCOUNT	Arab Bank	Cairo Amman Bank	Bank of Palestine	Bank of Jordan	Arab Islamic Bank	Egyptian Arab land Bank	Palestinian Investment Bank
Is there a minimum	yes	Yes	Yes	Yes			
If yes, how much?							
In JD	200	100	150	20	100	350	150
In NIS	1500	700	900	100	500	2000	1000
In USD	300	150	200	20	100	500	200
Any interest rates received	No	No	No	No	No	No	No
Chequebook - conditions	3000 NIS Balance for corpotaye clients and 100 for retail clients,not black listed	600 NIS Balance, not black listed	900NIS,not black listed	2000 NIS	not black listed	1000 NIS,not black listed	Not black listed
Any other conditions for opening a current account?	Proof of income	No	No			The minimum	

Annex 5. Overview Loan Products FATEN

NAME	GGLS	Individual I	Individual II	Fast	Family	Housing	Consumption	NGO/ FATEN Staff	Murabaha
Creation Date	1994	2000	2003	2000	2004	2005	2005	2002	2005
Client Type	All	All	All	Active clients in GGLS and IL1	All	All	All	FATEN and NGO staff	All
Loan Size (Min-Max)-US$	200-1,500	1,000-5,000	1,000-3,000	70-700 or 50% of current loan	1,000-15,000	1,000-15,000	100-1,000	1,000-25,000	All products may be disbursed according to Murabaha with same requirements
Avg. Loan Size (US$)	430	1,565	2,083	355	4,024	6,888	925	6,998	
Loan Duration	6-10m	6-24m	6-18m	4 wks	6-48m	6-48m	1-12m	1-48m	
Grace Period	no	No	no	no	no	3 months optional	No	No	
Requirements	Group guarantee	Credit history + postponed checks + promissory notes	Postponed checks; salary transfer; promissory notes	Promissory note	2 salary transfers for loans >5,000; 1 salary transfer for loans <5,000	2 salary transfers for loans >5,000; 1 salary transfer for loans <5,000	Postponed checks or salary transfer	Staff pension and severance	
Repayment Frequency	Bi-monthly or monthly	Monthly	monthly	Balloon payment after 4 wks	monthly	monthly	Monthly	Monthly	
Nominal, annualized IR	24%	18% for 1st loan; 15% repeat loans	18% for 1st loan; 15% repeat loans	48%	8% for loans >5,000; 5.5% for loans <5,000 (upfront for loans >5,000	8% for loans >5,000; 5.5% for loans <5,000 (upfront for loans >5,000	12% transferred salary guarantee; 18% postponed checks	5% FATEN staff; 7% NGO staff	
Flat/Declining	Flat	Flat	Flat	Flat	Flat	Flat	Flat	Declining / upfront	
Effective IR	40%	32-35%	27-30%	164%	14-16%	16-17%	32%	7%	
Fees & Penalties (US$)	4.2	10	50	11	50 or 1.5% (loans >5,000)	50 or 1.5% (loans >5,000)	No fees	No fees	
Major Changes since Creation	Currently being revised re loan size, duration, savings component, target group (men)	Fees	Loan duration	Will be revised re terms, duration	Interest rate, duration	IR	--	IR	

Source: FATEN

Annex 6: Overview USAID grants for lending and other programs

A. Home Improvement Loans Program (HILP)

HILP is a revolving loan program which began in 1995 in Gaza with the assistance of USAID. The program targeted low-income residents offering one to three-year loans to repair, expand or improve their homes. CHF signed a cooperative agreement with USAID on September 30, 1994, agreeing to manage the revolving loan fund, provided by USAID, and to jointly administer HILP with the Palestinian Housing Council (PHC). The agreement provided USD 4,000,000 in capital for loans (total award USD 5,022,935, the difference is for operating expenses). USAID project ended on September 30, 1997, and the program now operates on revenues generated from interest on loans.

On March 1, 2003, the Bank of Palestine terminated the MOA signed with CHF, giving CHF as three months notice (as agreed in the MOA). Therefore CHF has diversified the loan portfolio through the introduction of small business loan and loans to purchase apartments and land.

B. Palestinian Economic Opportunity Program for Lending and Economic Development (PEOPLED)

In December 2001, USAID and CHF signed a second two-year cooperative agreement for USD 2,600,000 to expand HILP into the West Bank. This amount included USD 1,400,000 in loan funds. Use of the remaining USD 1,200,000 was for operational costs. PEOPLED will improve the quality of life and stimulate private sector activity in the Palestinian Territories by increasing the range of financial services available to Palestinians.

In August 2003, USAID and CHF signed an expansion for the PEOPLED which was originally scheduled to end in December 2003. The new grant of USD 2,000,000 extended the PEOPLED duration for two more years (August 2005), enhancing its services in the Northern and Southern Governorates of the Gaza strip.

On April 26, 2005, USAID and CHF signed an expansion modification (# 4) for USD 2,950,000 to expand PEOPLED into three new cities in the West Bank mostly affected by the incursions and closures. The scheduled for completion date of this agreement is September 30, 2006. Expansion modification #5 (July 6, 2005) allowed for increasing the maximum loan amount to USD 15,000 and the monthly family income to USD 1,500.

Expansion modification # 6 (September 15, 2005) provided CHF an additional USD 1 million to enhance PEOPLED in the Gaza Strip.

Overview donor support (grants, soft loans etc):

Source	*Date*	*Amount (US$)*	*Terms*	*Currency*	*Status*
1. USAID Peopled	Dec 2001	US$2.6 million	Grant, 2 years	U.S. dollars	Fully disbursed
2. USAID Peopled	Aug 2003	US $ 2 million	Grant, 2 years	U.S. dollars	Fully disbursed
3. USAID Peopled	April 2005	US$ 2.95 million	Grant, 1.5 years	U.S. dollars	Fully disbursed
4. USAID	Sep. 2005	US$ 1 million	Grant, 1 year	U.S. dollars	Ongoing

II. Other Programs

C. Palestinian Infrastructure for Needed Employment (PINE/LIBERTY)

Singed by CHF International – Palestine with USAID in September 2004 – duration end January 28, 2006. Objective: provide support for Palestinian's infrastructure for needed employment. Amount: USD 1,999,920 for construction and rehabilitation of schools and youth centres in South Gaza in cooperation with the Ministry of Education.
Status: Completed in time and met all targets

D. Policy and Opportunities for Women and Entrepreneurs (POWER)

Agreement with US Department of State, Middle East Partnership Initiative (MEPI) for period July 1, 2005 until June 30, 2006. Second phase of a program originally implemented in Yemen. Budget is USD 605,370.
Objectives: (i) to support and advocate for and implement needed changes as related to identified barriers to women's entrepreneurship; (ii) to launch or expand women owned small and medium size businesses in West Bank and Gaza.

E. Palestinian American Recreation and Conservation Services (PARCS)

Cooperative Agreement with USAID
Period: May 5, 2005 to May 4, 2007
USD 3,989,978
Objective; Improve environmental and living conditions of Palestinians through the construction and rehabilitation of public parks that offer safe, accessible recreational sites for the Palestinians. Program is designed to maximize the use of local materials and labour intensive construction methods, which will help stimulate local economic growth by generating critically-needed employment in the most deprived areas in the West Bank and Gaza.
Status: Received an Intent to Suspend Notification from USAID

F. Empowerment of Palestinian Local Authorities (EPLA)

Cooperative Agreement with USAID
Period: October 1, 2005 to September 30, 2008
USD 21,000,000
Objective: The objective of EPLA program is to develop an enabling environment and operational framework for an effective, empowered and democratic local governance system in the West Bank and Gaza.
Status: Received an Intent to Suspend Notification from USAID

G. Islamic Development Bank Fund

Signed: April 11, 2005
USD 500,000. First tranch is USD 200,000
To support housing projects using Islamic methodology. CHF contribution is 50 percent of the loan amount. IDB has yet to decide whether funding is a soft loan or a grant. Therefore – for now – CHF has booked the USD 200,000 under current liabilities.

H. Other Programs

CHF is a major partner of the United Nations World Food Program (WFP) food for work and food for training program implementing it in the entire Gaza Strip and the 103 communities in Nablus and Jenin Governorates. The program provides food parcels for needy families in return for work days they invest in the development of their community infrastructure or basic services. If families don't have able workers then the head of household (mainly a woman in this case) would receive training in return for the food parcel

Annex 7 . P&L CHF Unadjusted

	Sept. 30, 2003	Sept. 30, 2004	Sept. 30, 2005
Revenues and Support			
Contributions from Local Community	58,185	28,550	71,050
Interest Income	5,458	1,651	1,707
Commission Income	49,707	91,796	131,034
Interest Income on Loans	306,459	381,559	482,123
Other income	34,384	52,119	75,530
Total Revenues and Support	**454,193**	**555,675**	**761,444**
Expenses			
Community Projects	6,339,872	4,792,631	1,066,587
Operating Expenses	1,833,269	1,463,217	1,090,988
PEOPLED operating expenses	*579,395*	*489,069*	*597,605*
HILP operating expenses	*19,991*	*13,501*	*51,068*
Bad Debt Expenses	19,481	20,652	12,560
Total Expenses	**8,792,008**	**6,779,070**	**2,818,808**
Change in Net Assets Before Other Items	**- 8,337,815**	**- 6,223,395**	**- 2,057,364**
Other Items			
Inter-Company Revenues - Fund Transfer	8,488,736	7,075,010	4,294,213
For PEOPLED	*950,030*	*1,043,422*	*2,941,930*
Inter-Compmany Expense Billings - HILP/PEOPLED	- 46,988	- 155,388	- 305,927
Inter-Company Expense Fund - HILP	-	- 100,000	- 150,000
Ligitation and Claim Expenses	-	- 167,426	-
Total Other Items	**9,391,778**	**7,695,618**	**6,780,216**
(B16+B23**)**	**1,053,963**	**1,472,223**	**4,722,852**
Net Assets Beginning of the Year	**- 4,236,833**	5,888,387	7,360,610
Prior Year Adjustments	9,071,257	-	
Net Assets End of Year	**5,888,387**	**7,360,610**	**12,083,462**